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RECENT DEVELOPMENTS IN MONETARY THEORY & PRACTICE

Sir Kikabhai Pre [illegible] adership Lectures

1940-41

BY

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PREFACE

This book embodies ten lectures delivered at Delhi University as Sir Kikabhai Premchand Readership lectures of 1940-41. According to the topics the lectures have been divided into chapters at the time of publication.

Monetary theory has passed and is still passing through a critical period of its history. At one time it could be said that monetary theory was one of the most definite things in economics. Now it is in a flux. In recent years the range of speculative theories regarding money has become very wide inasmuch as many advocates of such theories have monetary reform only as a secondary object—a sort of means—with the help of which to alter the basic structure of economic life. To what extent such a purpose will be accepted as a legitimate part of any scheme of monetary reform only the future can show.

In this book the opportunity has been taken to present a critical study of the main types of theories and their application as they have grown since the disorganisation of currency and credit after the war of 1914-18. Monetary practice, except under the abnormal stress of a complete breakdown, has been as conservative as some of the theoretical writers have been radical in their outlook. It is hoped that this short of study of the various schemes with a brief account of the practical measures adopted so far will help the reader to form an accurate idea both of the problems connected with monetary reform and of the complex interaction of economic measures in the modern world.

The author does not claim any originality for himself except in the presentation of the subject-matter and in evolving the complementary character of some of the schemes discussed in the book. But he hopes that he has not altogether failed in his earnest endeavour to present the facts of monetary reform in an objective and scientific manner.

He is indebted to many writers from whom he must have imbibed the ideas presented in the book.

P. B.

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CHAPTER I

Introductory

Recent developments in monetary theory and practice have been diverse and occasionally obscure. The orthodox gold system obtained in most of the countries of the world up to 1914 and was the ambition of the rest of the world to attain. At that time no currency was considered sound unless it was firmly based on gold and had gold in actual circulation. The value of gold was considered to be steady and its quantity sufficient for every monetary purpose all over the world. With the troubles which arose after the first European war of 1914-18 this complacent dream was shattered. The gold output of the world was found to be insufficient. The value of gold became much less steady. The concentration of gold in some countries, especially in the United States of America and its sterilisation there, accompanied by the shortage of its stock in many countries, showed for the first time the difficulty of gold adjustment of prices and the danger of the system of automatic operation upon the trade and production of a country. The scale of industrial progress was accentuated by the technical improvements made since the beginning of the present century as also the vast development and complexity of the structure of credit. During the war the currency isolation of the belligerent countries as also their desperate need compelled the adoption of certain monetary measures which would have been unthinkable in the older days. After the war the work of rehabilitation had started on orthodox lines but it was soon found that an immediate return to the gold standard was impossible. The interval had to be bridged with some system to be devised for the purpose. No country was ready with any alternative scheme. Thus a period intervened during which the old ideal was firmly retained as the ultimate goal but new experiments had to be made for the immediate present. Thus were initiated practical measures of monetary reform, which otherwise would have had no opportunity of obtaining facilities for actual introduction in any country. With monetary chaos

it was only to be expected that the attention of theoretical economists would also be drawn to the necessity for a scientific study of the new problems which came up in the economic life of the country. In this way several eminent economists came to study the special problems of monetary reform and to suggest various schemes suitable for the changed conditions of the world. A host of popular writers and enthusiasts also came into the field and suggested a series of confusing and often contradictory schemes of monetary reform. Once the idea that the monetary system was sacrosanct had been removed there started also wild speculation about what could and what could not be done with schemes of monetary reform. Soon it was realised that monetary schemes could also be utilised for other kinds of economic reform including radical changes in the basic organisation of the existing social structure. The currency and banking authorities, which have always been conservative in their ideas, were also compelled, mostly by the exigencies of the immediate situation, to adopt various reforms as experimental measures without accepting or without any idea of accepting any such measures as part of their permanent policy. These measures also formed the basis of speculation about further monetary reform. When schemes — usually sponsored by popular writers and advocating fundamental economic changes — began to appear the currency authorities in almost every country became highly suspicious of all schemes of monetary reform. An exception must be made in the case of the U. S. A. and Russia but here also the newer schemes were practically abandoned after a short while, especially those schemes which advocated monetary measures to be adopted for large-scale economic changes.

The periods of disastrous inflation in the twenties of this century and of the financial crisis in the thirties were particularly fruitful in proposals for monetary reform, for the old system had either completely disappeared or hopelessly broken down and could not be applied to the conditions of economic difficulty which suddenly had to be faced and surmounted.

Thus the most suitable period for the study of recent developments in monetary theory and practice is the one which immediately followed upon the termination of the war of 1914-18 and which may be said to have continued up to the middle of 1939. In the present treatise most of our study has been confined to this period and references to earlier periods have been made only in order to make

clear the back-ground of any scheme that has been proposed in theory or adopted in practice. An exception, however, has to be made in the case of two systems, *viz.* bimetallism and the gold exchange standard. Bimetallism has been an old scheme and may probably be traced back to the middle ages when the modern currency system was being evolved. We need not go so far as that for our present purposes. But we cannot fail to take account of the very great interest which it aroused as an alternative proposal to the pre-war gold standard. This was in France and the U. S. A. in the nineteenth century. In the latter country it never disappeared as a serious proposal of monetary reform and a Presidential election was even fought over the issue of bimetallism.

The gold exchange standard developed much later. It followed on the breakdown of the prospective gold standard which was introduced in India in 1893 and which broke down in 1902. It was officially recognised as a system about a decade later and was widely imitated after 1918; indeed its fundamental principle may be said to have affected almost all monetary systems during the last twenty years.

We shall consider the main proposals for monetary reform, that have been either advocated in theory or adopted in practice by any important country of the world. From the very nature of the problem we shall be compelled to consider each such scheme as a separate and independent proposal, for that will enable us both to explain the scheme adequately and to examine it critically with a view to discovering its defects. But it should be remembered that these schemes are not always independent of one another. Some are closely inter-connected and some economists have indeed supported more than one scheme to be simultaneously adopted as measures of monetary reform. In fact, there are a few such closely inter-linked schemes which are expected to be adopted simultaneously by a country in order to achieve the best possible results.

CHAPTER II

Cheap Money and Easy Credit

After 1914 when the first European war began the rates for money went up and continued to rise for several years even after the war had ended. The rise began as a result of Government need for borrowing. For war purposes every Government of a belligerent country had to find money on a huge scale. The daily expenditure of such a country mounted up to an extent which is almost unthinkable in terms of the financial figures preceding the war although these were high enough when compared with the figures of only fifty years before. Such vast sums of money could not be raised by taxation nor by selling foreign securities. Some countries like Britain had held such securities in enormous quantities. Even for them after a while it was impossible to cover the war expenditure by selling them. The neutral countries, especially those round about the theatre of war, suffered to some extent and had to borrow money for their current expenses. No special precautions beyond some war-time control were taken to regulate the money market and to keep down the rates of money. Those were the days when any such control or Government intervention which we find to-day would have been premature and would not have the support either of Government or of financial experts or of the public. Thus the normal forces of demand and supply were allowed to operate unhampered by any extraneous impediments. Nor was it fully realised how a rise in the rates of money would start the vicious circle of rising prices and rising wages.

If we compare the figures of public loans offered by the investing public at the time we find that there was a great increase in the amount available for Government borrowing. But the need for borrowing on the part of belligerent Governments was so great that no increase in the amounts offered by the public could have kept pace with the ever-growing needs of such Governments under the pressing conditions created by the war. Therefore, in the absence of proper control over the money market or of any special measures to regulate

the rates these latter went up very high. The surprise is not that they went up so high but that in the circumstances of the time the rates did not go up much higher than what they did.

The vicious circle naturally started almost immediately after the war had ended. During the war, as a result of rationing and other methods, consumption could not increase nor was there much opportunity of thinking about the special difficulties which were being created by rising prices. But when the war conditions ceased to exist there was little attempt made to stop the soaring prices. Even in countries in which the currency degeneration was not as hopeless as in some countries east of the Rhine there was a great rise in the general level of prices. Therefore, the lenders of money found themselves in a somewhat precarious position in that the value of money income from their lendings was going down. Naturally this made them ask for higher rates to compensate for the loss of value in their future income. They could ask for higher rates because of the continued demand for money. After the war the normal productive system had to be reconstructed in almost all the big countries. The belligerent countries had diverted their production for purposes of producing articles required for the war. Many of the neutral countries had also found it profitable to alter their normal course of production in order to supply the belligerent countries with war materials. Thus in the post-war period there was a further rise in the rates of money.

In all countries the money rates are to a great extent determined by the rates at which Government can borrow money. After the war of 1914-18 the financial position of many Governments became highly uncertain and in several cases, Governments were on the verge of bankruptcy. The consequent insecurity pushed up the rates at which Governments could borrow money in the open market. Also the amounts of their borrowings were very large. In almost every European country there was inflation. In some countries, especially in the countries east of the Rhine, the inflation was so great that it shook the foundation of confidence on which money ultimately stands and of which it is always very sensitive. The result was that even in countries, *e.* g. Britain, in which the process of inflation had been quickly stopped and even a proccess of deflation had ensued it took years to re-establish that complete confidence which was necessary to bring down money rates to normal level. Many countries, especially Germany, had to borrow money on an extraordinarily large scale in

order to keep up their industrial organisation. Thus borrowing in the international market—which meant the American and partly the British market—was going on at an abnormal rate. Extreme inflation had taken place in many countries which destroyed the economic strength of its people. Also the great destruction of property during the war had to be repaired. And this could be done primarily by borrowing.

Governments required funds for another reason also. During the war they had borrowed huge sums of money. The peace treaties had levied unimaginable sums of money as war indemnities which must be paid by some countries to others. These indemnities could be paid by any one or more of three methods. They might be paid in gold. But no European country had sufficient gold after the war. Or they could be paid by exporting the products of the paying countries. This was impossible as no country could afford to receive the whole of the huge amount of the indemnities in the form of products of the paying countries without ruining its own industries and thus throwing its own population out of employment. The third method was by borrowing. Obviously this is not payment but postponing payment and putting off the evil day. Thus Governments of defeated countries, in addition to their normal post-war borrowings, had to borrow huge sums of money in order to pay indemnities. The victor countries were saddled with large war-time debts and were incurring further debts for rehabilitating their post-war economy. The vanquished countries, in addition to this, had to borrow money to pay indemnities. The debt charges mounted so high that a very substantial portion of the revenue of almost every Government was swallowed up in payment of debt charges till all debtor countries including Britain and France simply refused to pay their war-time debts. This breach of faith may be said to be the most colossal that has ever happened in the history of civilized man. During the period when debts used to be repaid and indemnities used to be levied the expenditure on these accounts could be covered either by fresh borrowing which only created future difficulties for Goverment or by fresh taxation which crippled production.

All the foregoing causes combined in creating a persistent demand for cheap money. In the beginning this demand had only popular or academic support including that of Keynes, the great authority in currency matters in Britain. The currency authorities,

which are in every country highly conservative, did not approve of the idea of interfering with the deliberate object of making money cheap for a particular economic purpose. In fact, it is doubtful even to-day whether it is prudent to manipulate the money market for purposes which are mainly extra-monetary and economic. This popular demand suited the needs of Governments and other big borrowers as they would be able to reduce their debt charges by conversion loans. Economists also argued in favour of cheap money saying that this would lead to industrial expansion and thus to the increase of the productive capacity of the country. In the end the monetary authorities had to yield not because they were convinced but as a concession to the combined pressure of public opinion, economists, and Governments. Thus we find a period in almost all countries during which an attempt was made to keep money cheap by deliberately adopting measures in that behalf. In several countries this has been found to be so beneficial that it has been maintained to a moderate degree as a more or less permanent measure.

But cheap money is not always the blessing which its ardent supporters believe it to be. In the financial history of the world it has on more than one occasion either originated or helped the growth of unhealthy booms in business which could not be justified by the economic resources of a country. This is a real danger which has to be closely guarded against. Maladjustments in the economic sphere can be fostered by too cheap money leading to over-production and abnormal speculation. Cheap money will undoubtedly help the growth of industries if accompanied with other favourable factors. But in order to achieve the goal of all-round prosperity of the country with the help of cheap money it is necessary that the resources created by it and handed over to industrialists should be properly distributed among the industries and trades of the country. In other words, economic planning on a nation-wide scale is necessary before cheap money can be expected to do what its supporters expect. But there was no such idea of planning on a comprehensive scale when the pressure of opinion for cheap money had started. It will be correct to say that even to-day economic planning on the necessary scale has not been properly devised. We have our doubts whether it is at all possible to develop a system of such planning without an amount of compulsion and consequent deterioration of individual initiative in the industrial sphere which will permanently undermine

the economic strength of a country. But it is certain that without such an effective system of national planning for production and trade cheap money deliberately made so would certainly not ensure a proper distribution of purchasing power within the country. In the past it has been assumed in too facile a manner that the prosperity of industries in a country reflects the prosperity of all classes of the people in the country. This is not so in spite of the various measures of help devised for the sick, the old, and the unemployed and in spite of the phenomenal growth of trade unions in some of the highly industrialised countries. In the democratic countries and to a less extent, even in non-democratic countries. the masses are conscious, maybe over-conscious, of the great disparity in wealth distribution in times of so-called national prosperity. The political and social effects of this condition are so fraught with danger that their repercussion must be felt in the economic sphere as well. Concentration of huge profits during the war of 1914-18 first drew prominent and to some extent, malevolent attention to this fact. This was one of the acute national grievances just after the war when grave economic difficulties faced almost all countries.

A proper distribution of purchasing power not only means distribution of the profits of an industry among the producers in that industry. There may be and often is such maladjustment as between different industries. High finance has conferred many benefits upon the world but it has also shown that money does not necessarily flow into industries which need it most nor into industries into which it should flow. In fact, this maladjustment in the flow of money into different industries is one of the causes why there is over-production in some industries creating difficulties for some which cannot sell their products and for some others whose products can have a larger market than what they can produce if they are provided with sufficient fluid capital. From the national point of view this means creating a disharmony which is wasteful also in another way. The productive factors are diverted more into some industries where their marginal production is consequently low and are prevented from being used in other industries where the marginal production might have been higher. Thus the total amount of wealth in terms of values is not as great as it might have been. All this can be adjusted if there is a proper system of national planning provided that the assumption is correct that

national planning will be able correctly to gauge the nature and value of the products of different industries and that it is impartial enough to be able to distribute the national resources of the country among the various industries with rival claims for capital. Obviously the world has not yet reached the stage when this can be presumed. To the extent that this is correct to that extent it is also correct to say that cheap money alone is not the ideal solvent of the economic ills that beset the system of industrial expansion at present pursued as the goal by the supporters of cheap money.

Another consideration which need not detain us long is that a distribution of funds according to the needs of the various industries within a country is not the final solution of the question. There is bound to remain economic rivalries between different countries. High finance is a highly internationalised affair. It controls national finance or at least seriously affects its efficacy. Therefore, the final solution of the problem cannot be expected from national planning alone. International factors will have to be taken into account both for securing an adequate share of funds and for finding foreign markets for the sale of a country's products. It may not be too much to presume that the condition of the world is not propitious for such international co-operation in the economic sphere while its political and social conditions are so divergent and conflicting to one another.

In this connection it is worthy of note that there must be an economic balance within a country between the saving and spending of its people if the even course of its productive system is to be maintained without any undue or violent fluctuations. In normal times this is supposed to be done by the automatic variations of the money or interest rates. If there is more saving than what is good for a country's economic system it will lead in future to a greater accumulation of capital than what can be profitably employed in business. This will lead to a fall in the money rates and therefore greater production in the future. But greater production will not find a wider market within the country without an increase in consumption. This increase in consumption is possible if there is a fall in prices. If there is a fall in prices and consequent increase in consumption it means that there will be less saving and therefore less capital for future. With less capital the rate for money will rise. Thus the movement in the normal rates for money is a means to

bring about a proper adjustment between saving and spending or production of capital and of consumption goods. Too cheap money, created and maintained by artificial means, will naturally upset this equilibrium. It will lead to increased consumption and may be at the sacrifice of saving, thereby hampering the maintenance of that capital replacement which is essential for keeping up future consumption at the old rate. Such a reduction in saving obtained merely by artificial means of cheap money may frustrate its own purpose, for the less the future saving the higher will necessarily be the furture rates for money.

Another argument against cheap money is that its artificial adoption might endanger the re-establishment of the gold standard. After the war of 1914-18, probably even now, this was the ideal of all the countries of the world. It may be correct to say that quite a large number of countries do not want to return to the gold standard. But this will not solve the immediate problem. So far as the money market is concerned it is true that the whole world is, within certain limits, one unit. Therefore, if a few countries decide to keep away from gold there will be others who will like to stick to gold. The result will be the complications which are arising out of the currency *blocs* which have grown. The gold *bloc* with France as its centre wants to stick to gold with some disastrous results to itself, to which we shall have occasion to refer. The dollar *bloc* is really a potential gold *bloc*, for it is unthinkable that the U. S. A. will ever agree permanently to demonetize gold when it is the largest holder of gold reserves. For the time being it has been compelled by circumstances to sterilize its enormous stock of gold. But this cannot be done permanently without a heavy loss of national wealth. In effect that would mean that all real wealth in exchange for which the gold was obtained would be finally lost to the country. Indeed signs are not absent that the U. S. A. not only does not want to go permanently away from the gold standard but that it is attempting to introduce a system of bimetallism bringing back into circulation its own production of silver. The sterling *bloc* is at present off the gold and has done well without any link with gold. Even there all international financial relations with the gold and dollar *blocs* are on a gold basis. It is doubtful whether the countries of the sterling *bloc* themselves contemplate the future of their currencies without any relation with gold or any other metal. The

fourth *bloc*, that created by Germany in Eastern Europe and South America, is frankly based on barter and elimination of money. In this *bloc* methods of barter have been employed which can never place international trade on any basis of confidence between the parties concerned.

Thus we shall not be far wrong if we assume that as yet there is no serious tendency to leave gold permanently behind. No such practicable method has been devised which can be said to be acceptable to any country although a fair amount of academic speculation has come into existence. Therefore, if cheap money is deliberately introduced now, borrowing should in course of time be expected to increase. In fact, this is really the object of creating cheap money. But cheap money and the consequent increase in borrowing cannot be maintained long without reducing the cash reserves of the country. If the gold reserves are to be conserved, at some time or other the money rates will have to be raised in order to discourage further borrowing because of the fall in the reserves. This has not happened actually because the cheapening of money has not gone on for long and because the normal standard in business has not been reached in most countries owing to difficulties in international trade and owing to war industries which absorbed most of the new capital made available with cheap money. After that period it will be impossible to pursue the policy of cheap money without serious loss of gold reserves which alone can help a country to realise its ultimate hope to re-establish its gold standard, or if it has finally given up the idea of the gold standard, which alone can keep up its financial and business connections with the rest of the world.

If we turn our attention to the countries of the world in order to find out to what extent the policy of cheap money was adopted in any of them and study the results of this policy we find that under pressure of circumstances several countries introduced a deliberate policy to make money cheap. In Britain the sterling had been re-established on the gold basis in 1925. It is obvious that this could be maintained in and after 1931 only by raising the rates for money in order to discourage the outflow of gold which must continue if cheap money were to be introduced. It is a moot point whether the sterling attachment to gold could be kept intact by any reasonable rise in money rates which were none too low in 1931. But it is certain that the banking circles in Britain were influenced by strong

public opinion in favour of cheap money although they did not themselves believe in the efficacy of cheap money as a permanent national policy. Britain had to face, in its home and neutral markets, the competition of goods produced in countries with highly depreciated currencies and any rise in the home rates for money would have raised the cost of production of British goods. Public feeling which was fed by the writings of many pseudo-economists was too strong for British bankers whose traditional predilection for the glod standard inclined them towards the maintenance of, if not a rise in, the rates for money. British Government was also not anxious to see a rise because of the fear of political complications which threatened to ensue if the policy of making money still dearer were to be adopted. As a result this policy was introduced soon after the crisis and after the sterling had been disconnected with gold in 1931. This latter step was necessary since so long as the sterling was convertible in terms of gold it would be impossible to lower money rates without the danger of depleting the gold reserves of the country. By 1932 the bank rate was reduced from about 6 per cent to 2 per cent. Of course, this was partly due to the widespread economic depression and reduction of all foreign demand for British goods. But the policy of cheap money was deliberately adopted by Government and pursued since then up to the present time including the period since the outbreak of the second European war in 1939. Probably Government was helped in the pursuit of this policy by its balanced budget although critics deny this and say that even when Britain had deficit budgets its credit was higher than that of any other country in Europe and lower than that of no other country including the U.S.A. which also was having deficit budgets. Government also claimed that cheap money had helped to revive trade and therefore reduce unemployment. But this appears to be an exaggerated claim to be made for the year 1932-33. What can be legitimately claimed is that Britain was undoubtedly helped by the policy of cheap money when a few years later business revived as a result of the re-opening of the international market for British products. This was mainly the result of the rise in American prices and the depreciation of the sterling since it went off gold in 1931. Also about this time Government adopted the policy of protective tariffs for home industries in order to ward off competition from some of the Continential countries which had their currencies much more depreciated than the sterling in Britain.

In France an effort was made to maintain the price level by a policy of high money rates. London and Paris failed to co-operate in the matter. The former wanted the rates to be lowered in Paris whereas the latter asked London to raise them and adopt the French level. In this way in France the policy of cheap money was adopted by Government later than in Britain and other countries. The adoption of the policy by Government was further complicated by an unfortunate conflict between Government and the Bank of France, which resulted in a stalemate for some time and which made the Bank of France a target of attack under the succeeding Socialist regime. But Government, after hesitating for a while, took strong action and by decrees, reduced interest rates drastically.

In Germany the previous period of inflation had wrought such havoc throughout the country that for years it was not thought possible to advocate the policy of cheap money. Also the country was too dependent on foreign, especially American, borrowing to be able to pursue a definite policy of cheap money. This international borrowing on a huge scale, almost unprecedented in the financial history of the world, had to be continued in order to rehabilitate the country's economic system and to pay the enormous amount of indemnities. Thus for a long time the interest rates remained intolerably high. Ultimately the rates were brought down by drastic action by Government when it ceased to be democratic and was controlled by one well-organised group. Long-term loans bearing high interest rates were converted into loans bearing low interest rates in the course of a few months. Nominally this was a voluntary measure but really this was made under compulsion from above.

In the United States of America the financial and agricultural interests were too strong to enable Government to raise interest rates in order to prevent the boom which resulted in the financial crisis that began there in 1929 and in a couple of years, overwhelmed the whole world. The rates declined sharply as a result of the crash and the consequent disorganisation of the productive system of the country. Confidence was so deeply shaken that for some time money even at lower rates than in Britain did not find borrowers for productive purposes.

Thus the policy of cheap money may be said to have been pursued in most of the important countries of the world although the

benefits claimed for the policy are the result also of the reviving conditions of trade. It is doubtful whether cheap money alone could have done all that is claimed for it as the case of the U.S.A. showed. It is also doubtful whether cheap money can be maintained when trade fully recovers its normal level.

One way of making money cheap is to make it circulate more rapidly than before, thus enabling each piece of money to perform more work, that is, more exchange transactions, than previously. Several schemes have been suggested thus to make money cheap. In a way these may also be considered along with spending which we have already discussed. The object is to encourage or compel the holder of money to get rid of it as soon as possible. From this point of view the policy is to make money circulate more rapidly and should be considered as part of the policy of cheap money. But the holders of money can normally get rid of it by spending it in purchasing commodities. Therefore, this policy may also be considered along with greater spending. However, there is also an alternative way to get rid of money, *viz.* by depositing it in the banks. In such a case the policy helps to increase bank deposits which ultimately would make money cheap. Thus the new schemes which comprise the policy of more rapid circulation of money may encourage spending and may also encourage bank deposits. In the latter case they should come under cheap money, in the former case under spending. Therefore, we propose to discuss the schemes here immediately following a consideration of the policy of cheap money.

Several schemes have been suggested in this connection but we shall consider only a few which have received some degree of support among economists. One such scheme wants to charge negative rates on bank-notes. In order to reduce the volume of hoarded notes it has been suggested that there should be an automatic scale of reduction in the value of notes so long as they are held by individuals. This will compel the holders to make productive use of their money. They will be compelled to spend their money; this will increase employment by creating an increased demand for consumable goods. Or, they will be compelled directly to use their money for productive purposes by investing in stocks and shares. Or, they will be compelled to deposit their money in banks in which case the money, through the banks, will find its way to productive business. A variant of this scheme would go further and apply this scheme even to deposits

in banks, thus compelling the holders of money actually to spend their money. If they spend on consumable articles the scheme will really be a part of the scheme for greater spending. But they may use their money in purchasing stocks and shares, in which case the scheme would really be a part of the policy of cheap money. Even if the bank deposits are left without any charge they will help to expand credit, in which case the policy will be an aid to that of easy credit and the latter is always an aid to the policy of cheap money.

Another scheme adumbrated by Silvio Gessell aims at establishing what is called free money and has been made famous by receiving the support of Keynes who has done so because the scheme is an aid to his scheme of cheap money. The purpose of this scheme is not only to compel the holders of money to bring out for use the hoarded bank-notes but it wants to abolish interest rates. According to this scheme the bank-notes should be made progressively to depreciate from the date of their issue to the extent of one-tenth per cent per week, that is, about five per cent per annum. In order not to upset normal exchange transactions with the help of such notes their value will be raised to the original face value by attaching stamps to them every week to the extent of the depreciation. The holder being compelled to pay for these stamps will find the holding of bank-notes to be a charge and a penalty. After a period when the bank-notes will have too many stamps for attaching any more they will be exchanged for fresh notes which will go on circulating in the same way. Gessell thinks that by thus penalising notes which are idle the holders will be compelled either to spend them in purchasing consumable goods or to lend their money without charging any interest, that is, just to get rid of the penalty to be paid every week. Keynes supports the scheme and goes further than its scope by suggesting that means should be devised to prevent the evasion of the payment of the penalty by exchanging bank-notes for deposits, call debts, foreign money, or gold. This leads to the next scheme according to which the penalty should remain attached to the notes even when they have found their way into banks as deposits. Thus the banks will charge negative interest on deposits, that is, instead, as at present, of paying to the depositor they will deduct an amount out of deposits because the banks, being now holders of bank-notes, will be compelled to undergo the penalty, *viz.* the weekly depreciation of bank-notes.

The objections to these schemes would be the same as those to cheap money and excessive spending, which have been fully discussed in their proper places.

It may be stated here that none of these schemes have ever been actually applied in practice over a wide area or for a long time. The experience of an Austrian municipality or of a German commercial firm cannot be said to be one of currency reform even though, within limits and for a time, the experiments were successful.

A corollary to the policy of cheap money is that of easy and expanding credit. In modern business both money and credit are equally the means with which payment for goods and services is made. Therefore, we should consider the policy of easy credit immediately after that of cheap money. This policy advocates a liberal expansion of credit in order to provide for fluid capital to business. It should however be noted that expansion of credit is not the same thing as inflation. One may lead to the other. But it is always possible to have expansion of credit without any inflation provided that the country's currency has the system of automatic adjustment either by a rigid limitation of the paper currency or through an outflow of gold or cash reserves which can be maintained ultimately by a rise in the interest rate. This will have deflationary effect and check expansion as soon as it tends to show signs of inflation. So long as this precaution is observed or so long as the banking system works with due prudence within the law enacted for the purpose an expansion of credit need not, in fact cannot, develop into an inflation in the strict sense of the term.

The arguments in favour of credit expansion are more or less the same as those for cheap money. For the two policies, as stated above, really hang together. Also their objects are the same. When trade expands and more money is required the expansion of trade and employment may be hampered if the rules regarding cash reserves are not relaxed. Thus the advocates of this policy suggest that the cash ratio of banks should be made elastic either by relaxing the law or convention in this behalf or by an increase in the fiduciary note-issue of the central bank of the country or by its open market operations in purchasing securities. Most of the arguments in favour of and against the policy of cheap money apply, *mutatis mutandis*, to the policy of easy credit. Therefore, we need not be detained over them.

There is one serious objection to the policy of expansion of credit which has not been adequately realised by the supporters of the scheme. Credit is essentially a matter of confidence. No bank, however sound, can hope to be able to withstand a rush on itself for the withdrawal of its deposits if public confidence in its credit superstructure has been undermined. The very principle of credit organisation is that the bank does not keep a cash reserve equivalent to its deposits. Large portions of them are lent out and it is by such lending that credit performs the function of money and at the same time supplies capital to the trade and industry of the country. Therefore, although the bank may ultimately be able to withstand any demand that may be made upon it in the form of withdrawal of its deposits, no bank can do so if there is a sudden or immediate demand for such withdrawal. Therefore, it is essential that public confidence is first maintained. This confidence is not exactly a tangible factor and probably cannot be fully defined. But there is no doubt that it is based upon the general opinion about the stability of the currency and the extent of credit inflation. It may be considered to be a gross prejudice by the scientific economists that credit should have anything to do with gold or cash or bank-notes. But it cannot be denied that in the public mind gold has a value which is possessed by nothing else. It may be due to habits of people over centuries or it may have some substance of reason behind it even when there is so little stability in the value of gold as compared with its value in the pre-war days. But it is a fact of which no credit institution can fail to take notice. Therefore, when it is suggested that the only measure which is necessary for a great expansion of credit is a drastic reduction in the ratio of cash to credit in the bank's transactions one is apt to lose sight of a factor which has also a determining effect upon the nature and extent of credit expansion in the country. It appears that such expansion of credit on such a reduction in the cash ratio of the bank does not depend upon the law or convention set up in this respect. Rather the law or convention should be considered as the effect of the circumstances of the country which latter depend a good deal upon the extent to which a strain can be put upon public confidence in regard to the lowering of the cash ratio.

The policy was followed by several countries of the world, especially after the crisis of 1931 when the trade conditions showed some signs of recovery. In Britain the gold standard was suspended,

the budget balanced, and a great demand made asking Government to adopt measures to reduce unemployment. At the same time there was a rise in world prices, especially in America. As a result the policy of expanding credit could be pursued with great effect. Of course, this policy like that of cheap money can only help when other factors for economic recovery are already in operation. In itself it is of little use but it can be of great use and was used in aiding the productive system of the country when the causes of the depression had been removed and business started looking up.

In France the traditional policy of maintaining the gold value of the home currency came in conflict with the policy of expanding credit. This was attempted with some success within the country. But owing to the high value of the French currency it was not possible for French products to compete, in the world market, with the products of the countries with depreciated currencies, which included highly industrialised countries like Britain, the U. S. A., Germany, and Japan.

In Germany the psychological conditions were against any credit expansion. Exaggerated inflation had debased the currency so greatly and the financial ruin consequent on that policy had been so extensive that it was impossible to adopt any measures which might even remotely approach inflation. Economic recovery however was more rapid in Germany than in many other countries owing to several other measures which were vigorously adopted. This incidentally proves that cheap money or credit expansion is not an essential condition of economic prosperity.

In the U. S. A. also this policy was adopted as a means of recovery although its importance was less felt there owing to the other methods, on a grand scale, which were adopted for the same purpose and which raised the most acute controversy throughout the country during the first term of office of President Roosevelt. Any consideration of most of these measures will be out of place in this treatise.

On the whole however it will be correct to say that the policy of moderate and careful expansion of credit has persisted in all countries within the sterling and dollar *blocs*.

CHAPTER III

Purchasing Power

The supporters of cheap money and credit expansion have mostly been business people and industrialists. They have found this policy most helpful to their interests. But a more extreme group of people with Socialist leanings want to go much further and advocate a policy which would bring about a more fundamental change in the social structure. They are not satisfied with mere expansion of credit or cheap money. Their aim is to introduce more widespread changes in the economic conditions of the country. Credit expansion directly affects production and trade. If this is successful the consumers will also be benefitted through lower prices or at least a substantial increase in the quantity of consumption goods. Some Socialists advocate a more radical scheme of monetary reform in order directly to benefit the consumers. Their policy aims at increasing the purchasing power of the consumers, so that the resulting economic prosperity may be more widely spread than when there is only trade improvement. They also argue that this increase is ultimately the only sure way to maintain a higher level of production since production without a corresponding increase in the capacity of the consumers to purchase more commodities cannot be kept up for long except by an ever widening export market. This latter, in the modern conditions of the world, cannot be assured, especially when there are powerful industrial countries as rival producers. Moreover, such dependence upon external markets alone creates conditions of instability under which continued prosperity of home production cannot be expected. Also such dependence does not benefit the country so greatly inasmuch as the home country does not get the benefit as consumer although it does so as producer. They can rightly point to the last trade depression which commenced in the U. S. A. in 1929 and say that one of its causes was the mal-adjustment between production and consumption. The former can never be maintained at a high level unless simultaneously the

latter is also kept up at a correspondingly high level. At the same time it is also pointed out that in the present circumstances of the absence of any comprehensive system of national planning there may be over-production of some articles of consumption and under-production of others. This will naturally bring about an acute mal-adjustment between production and consumption and therefore reduce the total productive capacity of the country by diverting more productive factors towards the production of some articles and less towards that of others.

Thus they argue, with a good deal of force, that mere credit expansion or cheap money is no cure for the existing evils. That policy may stimulate production but it does not help consumption also to keep pace with production. Then the inevitable maladjustment will create a greater deadlock in the economic machinery. They say that a more effective means is to increase the purchasing power of the consumers so that demand for consumption goods will increase and in response to this demand production will be adjusted. In such a case the demand being more or less known, at least more reliably known than before, supply will naturally adjust itself with the result that trade expansion will take place along lines of production the market for which will be more assured. Therefore, maladjustment will be less likely to occur.

It is obvious that the reform advocated by the supporters of increased purchasing power is a much wider one than a mere reform of currency. They aim at a more fundamental, indeed a revolutionary, change in the whole economic structure. Therefore, this policy cannot be comprehensively discussed in a tract such as this book which deals with monetary reform. But within certain limits the policy affects monetary reform and must be considered here.

Some critics say that this policy can be said to be effective only when there has been an increase in the purchasing power of the whole country and not merely a re-distribution of purchasing power. In other words, this scheme can be successful only when there has been an inflation. The scheme is not so crude as that. In that form it would be crude because an increase in the purchasing power by inflation defeats its purpose by ultimately raising prices to the level of the increase in purchasing power. These critics lose sight of the fact that economic repercussions are not so simple as they

presume. Whether or not a re-distribution of purchasing power within the country will help trade and production will depend upon a multiplicity of varying factors. To the country as a whole there may be gain in wealth production if an industry which can be efficiently run on a larger scale with consequent decrease in the cost of production per unit is encouraged as a result of such re-distribution of purchasing power. A country may have natural facilities to produce one article more than another or it may have command over raw materials of one industry or over foreign markets for selling one article. Rival producers in other countries will have a determining influence. It is therefore rash to say that inflation is the only consequence of the policy which considers an increase in the purchasing power of consumers by its re-distribution among themselves. Whether a particular scheme of such re-distribution is sound or not is of course a different problem altogether

For obvious reasons we cannot here discuss the various schemes which have been suggested for increasing the purchasing power of consumers. Most of them go much beyond mere monetary reform although they indirectly affect money and credit. All of them however presume the existence or introduction of national planning which in its true sense does not yet exist in any country except to some extent in Germany just previous to the commencement of the present war and to a less extent, in Russia. It was because of this lack of the existence of a system of national planning that in several countries, *e. g.* Britain, the level of production could not be maintained in spite of high wages prevailing there after the war of 1914-18. This was due to maladjustment in production which left a large number of unemployed labourers whose consuming capacity was very limited. Some advocated an increase in the amount of doles given to the unemployed. But this can only create a vicious circle. For the increased help to the unemployed can only be rendered by higher taxation which will not increase but cripple national production.

In this connection it should be noted that this scheme expects a rise in the prices of the home commodities, which will benefit the producers and which will enable the consumers to pay higher prices for the commodities which they will consume. This feature seems to be closely connected with the successful operation of the scheme. We shall have occasion to deal with this aspect of the problem in

connection with some other schemes of monetary reform. Here we should realise the fact that any such rise in internal prices cannot remain unaffected by world prices. If internal prices are thus higher than world prices there will immediately be an increase in the imports of commodities from other countries in which prices are lower. Also any such rise in prices will immediately reduce the exports of commodities from the country to other countries in which prices are lower. Thus, after the prices have been raised in the country the problem will arise how to retain this rise in the face of competition from rival countries. This problem has been attempted to be solved—not very successfully as we shall see later—by adopting other schemes of monetary reform which aim at control of the external value of the currency or of the foreign trade of the country or even at economic isolation. Even if that can be successfully done the problem will not have been wholly solved. The scheme does not contemplate severance of international economic relations. The country adopting the scheme expects to retain and probably to expand its foreign markets, especially neutral markets in which it will have to sell in competition with the products of rival industrialised countries. It cannot therefore afford to pursue the policy of putting increased purchasing power into the hands of its people so far as this will entail a rise in internal prices unless it is at the same time prepared to adopt drastic control over its foreign trade or foreign exchange, leading, it may be, to economic isolation If any of the latter measures is adopted a portion at least of the market for its products will be cut off and the scheme will, to that extent, frustrate its original purpose.

This policy became popular in the circumstances which prevailed in most of the highly industrialised countries after the depression had started in 1929-31. In Britain and the U.S.A. high wages could not be maintained and the rates of wages fell much more rapidly than the fall in the cost of living. In Germany the fall in wages was so disastrous that for some time the masses of the people might be said to have been impoverished. The maladjustment in the world was so great that on the one hand large numbers of people were practically starving and on the other hand huge quantities of consumable goods were destroyed because they could not have any market for sale. The supporters of the doctrine of greater purchasing power could point to the fact that goods produced for sale had no selling value and had to

be discarded because the consumers did not have sufficient purchasing power to consume the goods although the consumers were in dire need of them. This gave an impetus to the popularity of the policy of deliberately expanding the purchasing power of consumers by monetary and other reforms of a drastic nature.

This policy has been extensively tried as an organised scheme in two important countries of the world, *viz.* Germany and the U. S. A. In the latter country it was adopted by the Administration as an economic policy. In the former country it was equally well established but not merely on economic grounds but on the principle underlying the system of totalitarian form of Government which had been introduced there within a couple of years after the commencement of the trade depression. Of these two countries the success—for success it must be called in the light of subsequent events—achieved by Germany was truly remarkable. After the war of 1914-18 Germany had little cash and its monetary system was so disorganised by the unprecedented inflation of its currency that it brought about almost a collapse of the country's economic system. For years it had to finance its industries by borrowing, mostly from the U.S.A. The money rates were none too easy and the loans, although short-term, were applied to finance industries which should be and are everywhere done only by long-term loans. Thus when the authoritarian Government which came into power early in 1933 started with its totalitarian plan of action the country was really in the midst of an acute economic crisis. It had neither cash nor credit. In any case almost the whole of its source of foreign borrowing had stopped. Thus purchasing power had to be created by artificial means. This was done by what may be termed the most amazing and bold of all banking policies ever inaugurated in any country. At the same time markets, especially in south eastern Europe and South America, were opened up by methods which cannot strictly be called economic. Within the country industries were simply ordered to take more operatives even though few extra hands were needed. This policy became so successful that in a short time unemployment was practically abolished. This meant that purchasing power had been successfully placed in the hands of the general body of consumers.

Yet it is doubtful whether this success can be really called the triumph of the policy of extending purchasing power in normal times for all countries. Industrial development hung round the production

of armaments on a huge scale which no country can hope to maintain for long nor should do so in normal times. Markets were enslaved by means which cannot be re-employed elsewhere once the trick of unrealisable credit was understood. Unemployment was abolished by summarily dismissing, even destroying, a large number of active workers and by a huge army of State employees for military and semi-military purposes.

In the U. S. A. the New Deal had for its object a substantial rise in wages accompanied with an increase in the number of the employed. The scheme is too fresh and too big to be dealt exhaustively here. The result was only a partial success due to the violent and bitter political conflicts which it aroused and to the vastness of the country with its diversity of economic problems to be faced in different areas. Wages were raised too rapidly and suddenly for the industries to be able to bear the strain of the increased burden.

In Britain the policy has never been adopted in its entirety. But some effect was given to it by the rise of wages to the pre-depression level. In France the opposite policy was pursued and cuts in wages went on increasing, with the result that purchasing power diminished leading to a fall in consumption. This reduced the French industries to greater straits than the industries of Britain, the U. S. A., or Germany.

CHAPTER IV

Government Expenditure

Keynes supports the dual policy of cheap money and extensive Government expenditure on public works. We have already dealt with the policy of cheap money. The other policy has been also supported by a host of other popular writers who are much less scientific in their outlook than Keynes and some of whose arguments would even contradict Keynes. They appear to have little knowledge of the bearings of a country's economic system and to aim at radical and unsound, even dangerous, results. We shall confine here to the purely economic view on which this policy has been advocated.

The main purpose of all measures for economic reform is to increase the prosperity of the country This will be done in all cases in which there is a substantial improvement in the system of production. Even an increase in production may not lead to continued prosperity unless there is a corresponding increase in consumption. This balance between production and consumption must be maintained before the consequent prosperity can be said to be well established. In order to maintain the flow of production and therefore of consumption it is also essential that a kind of balance is maintained between production and consumption on the one hand and consumption and saving on the other. The balance between production and consumption can be partly maintained if increased production is accompanied with an expansion of the foreign market in which the products can be sold. So far as the side of production and the interests of producers are concerned such an expansion of the foreign market may be sufficient to maintain them. But the home consumers may not always be benefitted if the home industries are dependent upon foreign markets. In such a case the home consumers may or may not be benefitted according as the corresponding imports are of consumption or capital goods. If the latter predominate the balance between consumption and saving may be so upset that the home consumers may be left without much benefit from increased production. Thus in

spite of the gains of producers the standard of living may not be substantially raised.

Owing to these considerations the advocates of the policy of extensive public works to be undertaken by Government argue that a proper and necessary corrective for such maladjustment is to put more purchasing power in the hands of the consumers. But their view-point is not Socialistic nor do they support the radical changes in the social structure which a direct increase in the consumer's purchasing power would involve. They advocate that such increase can be possible through public works initiated by Government on an extensive scale and the cost of such works is to be covered not merely by the current income of Government but by deliberately increasing the public debt.

In slack times and when a trade depression is on it is impossible, as we have seen before, to stem the tide of demoralisation merely by the method of easy credit extension. At such critical times confidence is shaken in business in general. Easy credit cannot be of much help. Therefore, it is necessary deliberately to encourage consumption by putting purchasing power in the hands of consumers through public works. If extensive public works are undertaken by Government at such times a large number of people would find employment and therefore be in possession of sufficient purchasing power to be able to maintain or even raise their standard of living and at the same time keep up the demand for articles which they consume. This demand will favourably react upon those industries, which produce consumption articles. Thus the increase of public works will support other industries. The workers engaged in these industries would not otherwise have been able to continue production and maintain their standard of consumption. This will, in its turn, help to keep up other industries whose products the workers of the former industries consume. Thus there is a whole series of good effects, the public works keeping up consumption of the products of some industries, which, in their turn, keep up those of others. Keynes, in fact, has gone to the length of calculating such increase in wealth and says that the increase in total national wealth or purchasing power is at least two and a half times more than the original Government expenditure on public works.

The advocates of this policy maintain that in this way purchasing power can be placed in large quantities in the hands of consumers

without the revolutionary changes in the social structure which would take place if the direct method of increasing purchasing power were resorted to. From this point of view the supporters of this policy are certainly moderate reformers steering clear of Socialism or of any fundamental alteration of the existing system. They further claim that this policy will to some extent make the working of the present system more smooth and effective by helping to maintain the necessary equilibrium in the production, consumption, and capital saving.

On the other hand it should be noted that when there is a trade depression the current income of Government also is reduced. The greater the extent of the depression the greater will be the need for large-scale public works and the greater also will be the reduction in Government revenue. At such times Government will have to resort to borrowing even to keep up its normal budgetted expenditure. Any reduction in the salaries and wages of Government employees will frustrate the object of the scheme by reducing the purchasing power of a large section of the community. The same situation will arise in the case of many industries during the depression. In order to prevent this fall in the wages of the employees of private firms the scale of public works must be such as fully to neutralise the effects of the depression. Government borrowing at such times will not only have to be large for extensive public works but must also increase in order to make up for the reduction in its current revenue in order to maintain the standard of salaries and wages of its own employees. The latter must also be done in order to do justice to Government employees, for otherwise they will suffer in the form of reduced purchasing power when the purchasing power of all other classes of people is being increased or at least prevented from falling. It is not certain whether any Government can afford to borrow on this scale at a time when a trade depression is on and when confidence is being undermined in every department of economic life.

Another point to be remembered in this connection is in regard to the method of public borrowing in order to initiate public works on an extensive scale. If the borrowing by Government is to be on a huge scale the money market of the country is bound to be affected. The rates for money will rise and the amount of fluid capital available for the trade and industries of the country will be reduced. It will be argued that the period being one of depression, there will not be

normal borrowing by business people and therefore it will be possible for Government to borrow money for purposes of public works. Even assuming that the amount of public borrowing will not be heavier than normal private borrowing and that it will merely take the place of reduced borrowing by private firms the supporters of the scheme overlook the fact that it is not contemplated that private borrowing should be reduced by the depression. The purpose of the scheme is to put sufficient purchasing power into the hands of the people engaged in public works so that they may go on consuming on the old scale; in fact, the purpose is to increase this capacity to consume. If that is so, it is only to be expected that other industries must go on producing on the same old scale during the depression in order to provide consumable goods for the consumption to be kept up or increased. Therefore, it is not contemplated that other industries, that is, private firms, should reduce their output. If they are to keep up their level of production they must obviously go on borrowing on the same scale as before the depression. Thus the amount of private borrowing is not expected to be less than before. Therefore, the contemplated situation is that private borrowing will remain intact and yet Government must borrow on a huge scale in order to start the public works. The problem needs statement in this clear form to realise how great a strain must be borne by the money market. In the circumstances nothing can prevent a sharp rise in the rate for money. It is doubtful whether any rise in this rate can procure—out of hoardings or imported capital—sufficient funds both for private firms and for Government. In any case the money rate must be very high. This will immediately create a vicious circle out of which it will be impossible to get away. High rates of money will raise the cost of production of all commodities. In order to maintain the home industries in their normal condition it will be necessary to put greater purchasing power into the hands of consumers than would otherwise be necessary. In other words, the public works must be on a wider scale and pay their employees on a higher scale in order to maintain, not to speak of increasing, the purchasing power of the people. Any such increase in the scale of public works and in the wages paid by them will cost more money. This means that Government will have to borrow more money. Every increase in such borrowing will further raise the rate for money and this will again start the circle with higher prices of consumption goods.

It may be argued that the industries of the country will not be able to run on the original scale of production and will not require the same amount of loans since their overseas markets are likely to be reduced by the depression which is rarely confined to one country. To some extent this argument is correct. But it is doubtful whether this reduction in the borrowings will be so much as to enable Government to borrow on a huge scale without substantially raising the rate for money. Of course, to the extent that the foreign markets will be cut off, to that extent there will be additional burdens upon the home industries, which must be made up by increased purchasing power of the consumers who are employed in public works. At the same time there will arise other difficulties owing to the foreign connections of the country. If by such artificial means of extensive public works internal prices are not allowed to fall and if the trade depression spreads to other countries as it must, there will be an increased stream of imports into the country from other countries in which the depression has set in but in which the scheme of public works in order to prevent prices from falling has not been adopted. To the extent that this happens the benefits from public works will accrue to other countries and not to the country which will undertake the heavy cost of such works.

From another point of view this policy must be said to be radical as compared with the orthodox policy of public saving which has grown almost sacrosanct during the last one hundred and fifty years. Since the industrial revolution of the eighteenth century the size of industrial units has gone on increasing and mechanisation has proceeded on such a scale that capital has had a dominant place in all large industries. In the early days the question of production was the main, if not the only, problem. Markets were abundant and the problem of selling the products did not exist. The superiority of the factory system thus established by organised capital on a large scale was so patent and its products so cheap and efficient that the world markets could easily absorb the whole product of industries however large these might be. Britain had the start and had the advantage of a disorganised Europe after the Napoleonic wars. Even when France and Germany became industrialised the overseas markets were there. Gradually, of course, competition became more and more acute. But generally it will be correct to say that the problem of markets became acute only towards the end of the

nineteenth century and the full effects of it felt in the present country. As a result of this continued industrial growth for more than a century the orthodox policy of public saving became well established. According to this policy a country is likely to prosper if it goes on increasing its output for foreign markets. With that object in view it should go on saving as much as possible so that future capital may increase in order to help future expansion of industries. This policy of saving as against spending could be so successful and therefore so well established in the minds of men because the wealth production was on so vast a scale that the saving, large as it was, was not at the cost of spending. For during this period the standard of consumption of all industrialised countries was also steadily going up. Thus this policy of saving became an integral part of the orthodox national policy. It became so successful that the amount of capital became in fact too vast to be profitably employed within the country and was, as in the case of Britain up to 1914, invested all over the world. Hence the loss of equilibrium, which had started in the last quarter of the nineteenth century, could not force itself to the notice of economists till recent years.

In a sense therefore it will be correct to say that the policy of greater expenditure than saving, which is the reversal of the old orthodox policy, is inevitable, arising as it does out of the circumstances of the times. To this extent the new policy is justified and thus has a firm basis in economic facts. But there is another aspect of its application, which is much less free from criticism. This policy advocates extensive public works to be undertaken by Government. The question therefore arises whether this scheme is to be carried on out of the current income of Government or whether it should be financed by public loans. If it is the former the post-war condition of no Government could allow it to finance public works on as extensive a scale as would be necessary in order to bring about the desired results. To be able to give employment on a large scale and raise or maintain the standard of living by putting sufficient purchasing power in the hands of the masses of the people the public works must be on a very large scale. Obviously this cannot be done out of the current revenue of Government. Therefore, it would be necessary to raise public loans the magnitude of which will, in contrast, make even the war-time loans look insignificant. Of course, this can be done only by having deficit budgets by

Government. Here again the new policy comes into collision with another orthodox policy which has been well entrenched for centuries as a policy of sound Government finance. The old idea, which still persists everywhere and does not yet show much sign of giving way, is that Government credit is in a way the foundation of the country's credit strucuture and that Government credit is undermined by continued deficit budgets. This would certainly be so if the deficits were to be so great as are contemplated by the policy which advocates the undertaking by Government of extensive public works on a large scale. The old idea was, and perhaps the idea even now is, in favour of the opposite method, *viz.* that all capital expenditure should be incurred only out of current revenue. Current revenue in modern times practically means taxation. If public works on the scale advocated by the supporters of the new policy were to be financed by taxation alone the amount of the taxation will be so heavy that it will crush out of existence most of the present industries and will swallow all of their profits. Thus the policy will only be frustrated if this attempt were to be made.

The new policy therefore advocates the deliberate creation of deficits in Government budgets in order to finance public works. The result is expected to justify the means. The expected results will be extension of credit and increasing the purchasing power of consumers. This will maintain and even raise the standard of living. Also the modern trade cycle which periodically ushers in a crisis in the present capitalistic system will be eliminated or considerably reduced in intensity. When depression begins Government will start with its large-scale programme of public works and thus prevent the consequent unemployment and loss of purchasing power. Some economists including Keynes have emphasised this aspect of the result of the new policy and there appears to be considerable force in the argument.

But there is no getting away from the fact that if this policy is deliberately pursued by any Government public debts must continue to increase. It is argued that the fear of increasing public debts is more psychological than real and that people get used to public debts more easily than we imagine. The history of public debts is quoted in this connection. In Britain this bogey of high public debts has been periodically raised since the American War of Independence. But every time the country easily bore its debt

charges and the subsquent increase in national wealth was so great that these charges could easily be paid out of taxation. Even the debts of the war period of 1914-18 did not look so formidable a dozen years later. It is also argued that public debts make Government keep an alert watch upon and a close touch with the financial markets. Thus Government has a real business interest in monetary problems and financial transactions, which is a help towards stability in such matters. In this respect the interest of Government is very much allied to the interests of the general body of producers in the country and Government intervention in financial matters becomes more assured and more continuous. As Government works through the chief banks of the country, especially the central bank, the country's interests are looked after more directly than if Government were a merely uninterested spectator of the situation. Management and control of the money market as also credit expansion at suitable times become easy and definite, and this factor helps to create confidence in any abnormal condition short of a crisis. The crisis itself, when it comes, is expected to be less acute if the new policy of public works is adopted at such times. Further, it is argued that the new policy will vastly increase the corporate wealth of the country by thus creating public wealth which it can never be the private interest of an individual or company to do. Such corporate wealth will very much increase the amenities of life as also help the production of wealth by private individuals or firms. This indirect encouragement to production of wealth is likely to offset to a great extent the disadvantages of deficit budgets or at least to compensate Government by creating additional taxable sources for future, thus indirectly augmenting the sources of Government revenue. In any case the debt charges can be lightly borne by a more prosperous country and the weight of public debts will be felt less in proportion as the total wealth and amenities of life develop in a country.

There is no doubt that the weakest point in the whole scheme is the deliberate and continued deficits contemplated in Government budgets. Up to a certain point such deficits do not shake public confidence, because Government credit is usually much greater than that of any other organisation. But as could be seen in the era of inflation in Europe just after the last war such deficits can be pushed too far and bring about a total collapse of Government

credit. At such times it is not easy to stop the collapse or take action for revival of credit without heroic measures. Thus it must be admitted that the policy of continued budget deficits can only be carried up to a limit. As against this objection to the policy of constructing public works by the State it should be noted that the supporters of the policy do not always advocate a continuous programme of public works. Some are cautious enough to say that the scheme should be kept ready and put into operation whenever depression threatens to overwhelm the economic life of the country. If this is so continued budget deficits are not contemplated except when there is an impending trade depression. To this extent of course the scheme becomes less objectionable from the orthodox point of view. But at the same time this caution also makes the scheme less effective. For if action is taken only at times of depression it can only be a preventive measure against further unemployment or sagging of the standard of living; even that will depend upon the extent of the trade depression. If operated on such occasions only the scheme cannot reduce unemployment nor raise living standards nor be used as a permanent lever to bring about and maintain economic prosperity.

Another consideration which arises in connection with this policy is the nature and utility of public works thus started by Government. Of course, these may be, and in the minds of ordinary men are usually connected with, public works of general utility or works which are expected to help the expansion of production and trade in the country. For example, the construction of a town's water-works will be of general utility to the whole population of that town. Or, the construction of a railway or road or bridge or canal may serve the twofold purpose of conferring general utility upon the neighbouring area and also helping production or trade in future. This latter will directly contribute to the increase in the production of wealth of the country and may even rank as capital investment. In either case the economic prosperity of the country will increase. But one need be consciously aware of the facts as they have been present. In recent past public works have, in several important cases, meant work which has no direct economic value. If, for example, Government accepts the new policy and starts factories producing armaments the economic advantages claimed for the scheme become strictly circumscribed.

Further, there may be diversion of emphasis from true economic causes to accidental ones by an over-zealous pursuit of this policy, especially in old and well-established countries like Britain. It is well-known that in such countries industrial plant and organisation and methods may have grown obsolete merely by flux of time and may require renovation on a wide scale in order to make them up-to-date and put them on a competitive basis with countries which are newly establishing them or which, owing to extensive dislocation during a prolonged and ruinous war, have started them afresh. A depression caused by such events is ultimately good for the old country as it is compelled also to introduce radical changes in its methods of industrial organisation. In such a case if, as soon as the economic depression starts, it is assumed that public works should be started in order to overcome the difficulties attention is only diverted from the inherent economic weakness to the superficial fact of depression. For even if the tide of depression is thus stemmed the general industrial weakness will remain and reappear as soon as the immediate difficulties have been surmounted by the policy of public works by Government.

Again, we should not lose sight of the fact that this policy presumes the existence, to some extent, of economic planning. Of course, works of public utility will confer benefits upon the population even if they are haphazardly determined and executed without any relation to one another. But if they are to be most effective and if their construction is to be pursued as a policy they must be decided upon with a full scheme in view in which their inter-relation to one another and to the general economic life of the country must be taken into account. Therefore, economic planning on a national scale is inherent in the system. All our objections to such Government action when a comprehensive economic plan does not exist will thus apply to this policy as well.

Turning now to actual cases where this policy has been adopted by Governments we find that there are several such cases in the recent history of the world. Here we should make a distinction between the deliberate acceptance of this policy as part of monetary reform and other cases in which monetary reform was not the principal object. The latter is beyond our purview. Such a policy will be part of a scheme of monetary reform if it leads to an expansion of credit or rise in the level of prices or increase in the purchasing power of consumers. It is possible to have any or all of these results in consequence of a

Government policy of constructing public works. If they are on a sufficiently wide scale there will be a general stimulus to various other industries and will lead to an expansion of credit which usually follows a period of industrial revival. The level of prices will be raised if the distribution of such works throughout the country has been such that the masses are benefitted by the construction of such works. The workers employed will have more purchasing power. Even when the result is non-monetary, *e. g.* to reduce unemployment, it may lead to monetary reform at least by helping to reduce the contraction of the purchasing power of consumers, which otherwise might result.

The operation of this policy on an unprecedented and huge scale could be seen in the United States of America during the second term of President Roosevelt's office, especially in 1937-38. It should be noted that Roosevelt's object was not only nor primarily monetary reform. Therefore, his scheme was much wider than what can be legitimately considered here. But the result of his policy had possibilities of far-reaching monetary reform which failed in this respect owing to the vacillation of the Administration since an extraordinarily big scheme was suddenly put into operation without the corresponding inflation in currency without which such a scheme could never have succeeded. It was a bold scheme, the boldest economic plan ever conceived in the history of mankind. But in its execution it was one-sided and failed in its primary monetary objective in that it was not accompanied with the essential credit expansion and that it could not bring about a uniform rise in prices. The credit expansion was inadequate because the inflation was not sufficiently large and neither the Administration nor business people ever thought that the U. S. A. with its huge gold resources could or should have a regular inflation. Thus the inflation psychology failed to materialise. Without this psychological reaction revival of business on the contemplated scale could never be successful. Business men must catch what may be called the fever of revival, having faith in its success. They must anticipate and hope for a general rise in prices. There must be created that atmosphere of trade optimism which will induce them to expand and extend their business in order to benefit by the anticipated rise in prices, The result was a lack of uniformity in the rise of prices. Owing to certain non-monetary measures adopted by the State and the propaganda drive of the Administration prices in agricultural and mining products increased but there was no such

increase in the manufacturing industries. In the end the scheme failed—it must be said to have failed in spite of local successes—in so far as the aspect of monetary reform was concerned. Here and there it did put more purchasing power into the hands of consumers. But in general and taking the country as a whole the extension of credit was inadequate, the rise in prices was not uniform, and the increase in consumers' purchasing power undoubtedly ineffectual. Therefore, as compared with the vast amount of money spent by Government and as compared with the huge increase in the public debts the result must be said to be poor and the scheme adjudged to have failed.

In Britain the policy of public works was never really adopted by Government. In 1935 a sort of half-hearted scheme was developed. This was really under political pressure, especially as a counterblast to the ambitious scheme of public works which was announced by Lloyd George as part of his election pledges. Government did not contemplate either inflation or borrowing but expected the building schemes to be financed out of current revenue. Obviously this in itself could neither expand credit nor increase the purchasing power of consumers. The only thing which was done, as noted under the section on cheap money, was to keep the money rates low so that the trade revival, of which signs were not absent in 1935, could be accelerated. Borrowing, however, was extensively resorted to by Government for rearmament after 1937. This partly helped this kind of monetary reform but the purpose, being political and military, was strictly circumscribed from the point of view of monetary reform.

On the Continent public works, especially of armaments, were undertaken in Germany but for wholly non-monetary purposes. In fact, the Government policy was simultaneously to counteract any monetary effects of the policy. In spite of this there was a rise in prices, which was considered to be undesirable. In some other countries including France construction of public works was taken up not as a policy but as a purely temporary measure to alleviate the distress caused by widespread unemployment. Its effect upon monetary reform could not be continuous or pronounced.

CHAPTER V

Central Bank's New Role

Keynes has advocated for a long time a new scheme of monetary reform in which the central bank of the country is expected to make a new departure in its operations in order to bring about an adjustment in the spot rate of interest and the forward exchange rate. His scheme in its maturity further contemplates co-operation between central banks of different countries in order to achieve this end.

The need for such adjustment arises from the fact that there is divergence between the interest rate and the forward exchange rate. Such divergence may arise for various economic reasons operating in different countries of the world, which have intricate financial and business connections. The result of such divergence is that automatically one affects the other. A change in the interest rate will affect investors and speculators in determining the flow of foreign holdings in the country. Thus if there is a rise in the interest rate in the home country or a fall in the interest rate in another country this will lead to an inflow of foreign holdings into this country. Conversely, a fall in the home rate or a rise in the foreign interest rate will have the opposite effect leading to an outflow of foreign holdings. The spot rates of interest in two countries with close business connections cannot be different for long, one quickly reacting upon the other, and very soon the two will be about the same. The trouble arises when forward exchange rates between the two countries are different from the spot rates. If the forward rate becomes adverse—that is, if in future the home currency is expected to depreciate in terms of the foreign currency—there will be an outflow of foreign holdings. At such times the existing method used as a corrective is to raise the interest rate in order to retain or attract foreign holdings to the country. But a rise in the spot rate immediately affects the money market and creates hardship for business. The problem therefore is

how to retain foreign holdings without a rise in the interest rate. The new policy suggests that the central bank should intervene in the operations of the forward market and by altering its forward rate, retain foreign holdings. Thus their future outflow will be prevented and at the same time the interest rate remaining the same the hardship to business will be obviated.

If the interest rates in two countries vary, immediately forward rates will also alter and bring about an adjustment. If the interest rate in one country rises the future tendency of an inflow of foreign holdings will be offset by an adverse move in the forward rate, thus neutralising the effects of the rise in the interest rate. But this will take time. And as the forward rate is affected by many more factors than those which operate on the interest rate the time taken for readjustment is longer than what it would otherwise be. During this period of transition difficulties will arise. The country with lower interest rate will lose gold and foreign holdings to the country with a higher interest rate. In order to prevent this the country losing the holdings should, according to the new policy, have its central bank operating in the forward market. The central bank is the institution which is ultimately responsible for and which controls the country's reserves. Therefore, it is the proper body to take action in the matter whenever the need arises. The purpose of such intervention on the part of the central bank will be to make the home currency appreciate in terms of the foreign currency so that the foreign holdings may not find it profitable to be sold at home and transferred to the other country. Thus the central bank is expected to deal directly for forward purchase at rates which will exactly neutralise the advantage obtained by the transfer of funds to the other country by the higher interest rate there. This will encourage the retention of foreign holdings in the country.

If the retention of foreign holdings or attracting them to a country were always beneficial to that country every country would try to do so and there could not be any co-operation between the central banks of two countries in this matter. For the gain to the other country would make a country reluctant to join in any scheme which will help the first country to retain its funds and prevent its flow to the other country. But increase in such funds is not always necessary or desirable in the interest of trade between the two countries. If owing to the high interest rate there

is too great an inflow of foreign funds into a country, its interest rate will have to be lowered considerably. This also may have an undesirable effect by making money too cheap and thereby encouraging booms in the trade of the country. This undesirable condition can be prevented by sterilizing its reserves, that is, by making them dead so far as productive work is concerned. This does not help the country nor its central bank. Also it should be remembered that this frequent transfer of funds is expected to be purely temporary. For, in course of time, the depletion of funds from the country with low interest rate will push it up there and the influx of funds into the country with high interest rate will push it down. Thus flow of funds in the reverse direction will start after a time. This fluctuation in the interest rates in both the countries is deleterious to the interest of both. Therefore, it will be to the interest of both the countries to control movements of interest rates as also the flow of funds from one country to another. This latter can be done by both countries co-operating, through their central banks, in controlling the flow of funds in such a way that there is not too great fluctuations in their interest rates. Thus co-cperation between two countries is possible and desirable.

The difficulty arises in two ways. One is in regard to the original position. If both countries can arrive at a satisfactory decision regarding their relative holdings of foreign funds it will become easy for them to adjust their interest rates and also their forward rates in such a way as to hold the foreign funds at particular amounts. But this is difficult to achieve. At present most countries are dissatisfied as to their own holdings and try to have more in order to put their industries in larger funds, that is, by trying to make their money cheaper. Thus continuous manœuvring for the position of better funds is going on everywhere, leading to acute rivalry between different countries. Also the industrial progress in no country is static. Therefore, if one country is progressing faster than another it requires more funds and therefore tries to get more. In many cases such development arises out of the successful operation in foreign markets in which more goods can be sold. If more funds are to be obtained from another country the latter not only loses funds for its own development but may resent the process if it is jealous of the developing country and hopes to sell its goods in the same foreign market in which the other country expects to sell and

for selling in which market it wants more funds for its own trade and production. The second difficulty which may come in the way of fruitful co-operation between two countries in adjusting the amount of foreign funds by joint control over the interest and forward rates is the uncertainty regarding the value of the currencies. Very few currencies in the world have now any fixed value since they went off gold about a decade ago. The values of most currencies are in a high state of flux. Therefore, it is not easy for two countries to come to any agreement about the values of their currencies. If there are frequent changes in the value of the currency of any one country its relation with another country so far as its interest and forward rates and consequently its gold and foreign holdings are concerned is immediately upset. This is one of the reasons why several important countries have tried to link their currencies with those of other countries. This has led to various currency *blocs*, *e. g.* the sterling *bloc*, the gold *bloc*, the dollar *bloc*. Such *blocs* have made adjustment as between countries within the same *bloc* easy to achieve but have made inter-*bloc* co-operation somewhat more difficult by making more prominent the currency differences between the *blocs* themselves.

Subject to these disturbing factors it is possible and desirable for two countries to co-operate in keeping their interest rates in harmony with their productive works by co-ordinating their forward rates in order to prevent the flow of foreign holdings for purely temporary purposes. A sudden rise in the interest rate is always undesirable. A sudden fall in it may also be undesirable, especially when there is danger of its leading to a speculative boom. At such times the interest rates in the two countries can be stabilised by the central banks in the two countries operating in forward rates in such a way that the flow of foreign funds is prevented from the country in which the interest rate is low to the country in which it threatens to go up.

It should be noted that this policy can be successful only when the central bank operates to retain or augment its foreign holdings which may flow out for purely temporary reasons and are expected to return as soon as the normal adjustment between the interest rate and the forward rate has taken place. During the time which must inevitably elapse between the interest discrepancy and the adjustment the disturbing factor is eliminated by the central bank's operation in forward rates. Such reasons normally are speculative or seasonal

or connected with arbitrage operations. But if there is a deeper maladjustment such operation on the part of the central bank will be worse than useless If, for example, the economic development of the two countries has diverged considerably from its original position of equilibrium and as a consequence more funds are permanently necessary in one of the countries, foreign funds must ultimately be transferred to that country and the attempt to check such flow will be futile and may even lead to a crisis. Therefore, the central bank can successfully follow this new policy only if it can successfully discriminate between temporary causes of flow of funds, which will later be neutralised by normal causes, and permanent need for such flow for economic reasons. This is not difficult at least over short periods of time during which large-scale economic changes are not possible. After that such action becomes more difficult, being a question of proper discernment on the part of the central bank. The matter becomes more complicated in international banking co-operation, especially when one country is losing in the race of economic prosperity and its central bank is expected to agree to a permanent outflow of foreign funds to the other country which is gaining in economic development.

In order to be effective the new policy must be consistently and determinedly pursued by the central bank to an unlimited extent. If the interest rate is to be kept lower in the face of higer rates in the neighbouring countries the forward rate in the country concerned must be made favourable and must remain favourable so that foreign funds will not flow out. The central bank must therefore be able to operate on a scale and for a time which are sufficient to enable it to do so effectively. It must sell for forward delivery to an unlimited extent and sell outright without being able to cover or hedge. The latter will obviously frustrate the object as it will affect the interest rate on the spot. Here also a difficulty may arise. Such sale – or, in the opposite case, purchase—for forward delivery may be needed on a vaster scale and for a longer time than the resources of the central bank will allow. At that point the whole scheme must break down without any remedy being left for the bank and things must be allowed to drift with the consequent uncertainty and dislocation in the business of the country.

So far as fluctuations in the relative values of different currencies are concerned one may contemplate several different cases. If

two currencies are linked with gold and the link with gold is secure —this can be said of no currency of the world at the present time— the adjustment of rates between the two countries becomes easy as it used to be before 1914. If the home currency is fixed in gold and maintained as such the need for the operation of the new policy for its central bank will arise only on abnormal occasions when there is a sudden or heavy demand on its reserves. If the foreign currency is linked with and stabilised in terms of gold such a policy may be superfluous. If the foreign currency is not fixed in terms of gold and keeps on fluctuating there may arise grave risk in buying foreign currency in order to increase foreign holdings since there can be no control over the fluctuations in the value of the foreign currency. If the home currency is not fixed in gold its value will fluctuate but uncertainties due to this need not be great since its value can be and should be properly controlled by the central bank. If none of the currencies are fixed in terms of gold and if both keep on fluctuating the result will be chaos leading to so much uncertainty and probably jealousy and suspicion between the two countries that no co-operation between the two countries may be possible and there may be a complete breakdown in the economic relations between them. At present no country has a currency strictly fixed in terms of gold and none which can with confidence maintain the value of its currency. This detracts from the effectiveness of any scheme by which the central bank can stabilise its money rate on the spot by operating in the forward market.

Thus we find that the policy as developed by Keynes can be successful only under two conditions, *viz.* so long as the central bank has the capacity to sell or buy in the forward market to an unlimited extent and so long as the maldistribution of foreign funds is due to temporary causes, for there can be no effective control when broad economic reasons require extensive transfer of foreign funds from one country to another.

In actual practice no country has so far adopted this policy even as an experimental measure. The central banks are probably too conservative to do so and look upon any forward dealings as too speculative and therefore too dangerous to be undertaken by central banks or even by ordinary banks. Once or twice the exchange control in France may have bordered on such operations but this was never repeated nor accepted as a policy to maintain the current

interest rate. In Britain the Exchange Equalisation Account has never done anything except to control the interest rate leaving forward exchange to take care of itself. In 1931 Government directly intervened to prevent the flight of foreign holdings when forward buying was extensively resorted to. The immediate depreciation of the sterling was stopped and withdrawals of foreign funds ceased. The only other example quoted by the supporters of the new policy is the case of Holland. But the policy was neither deliberately adopted nor even recognised as such by the banks. Here the central bank used to bring indirect pressure upon the ordinary banks not to buy guilders held by foreigners except when sold as part of regular business. This is far from the policy which wants the central bank to buy or sell forward exchange to an unlimited extent in order to prevent movements of gold and foreign holdings in response to speculative transactions or seasonal fluctuations.

We may conclude that although there is considerable force in the arguments of Keynes and others in favour of the central bank's operations in forward exchange in order to adjust the inflow or outflow of foreign holdings and although theoretically there is little reason to disallow the central bank from doing such transactions within definite limits no country appears to have adopted the method. In fact, conservative ideas looking with horror upon any speculative transactions by the central bank are so strong that there does not appear to be any chance of this policy being adopted unless there is an almost revolutionary change in the outlook of central banks in regard to proper banking functions.

CHAPTER VI

(a) Gold Reserve Surplus

A monetary reform has been suggested, which appears rather startling at first sight. It is said that sufficient surplus in terms of gold can be created out of the existing inadequate gold reserves by a sudden and drastic reduction in the ratio of the value of the currency in terms of gold. The suggested scheme reduces the value of the currency to one-fourth of what it is at present. Thus if the same gold reserves are considered just sufficient to maintain the present value of the currency, one-fourth of them will be now necessary to maintain the new lower value of the currency. The other three-fourths of the reserves will leave a large margin to the country in order to enable it to meet all possible international demands and at the same time leave to the country a large amount upon which to build up fresh credit.

A two-fold benefit is claimed for this scheme. It is said that most European countries suffer from the burden of fictitious wealth which was created or acquired during the war of 1914-18 and the boom period immediately after the war when there was currency inflation. The value of this wealth was fictitiously raised by a return of the currency to the gold standard, which meant deflation. If therefore the value of the currency is now reduced to one-fourth or so of its present value the value of that fictitious wealth will be similarly reduced and the country will get rid of wealth whose value was not at the time of its creation or acquisition and is not now as high as it is on paper. Apart from the fact that this will be unfair to those who have acquired any part of this wealth later on by paying the normal market value as it stands now the scheme overlooks the vast amount of wealth which has always existed in the country apart from the so-called fictitious wealth. The adoption of this scheme will mean economic ruin to a large class of people, especially those who have laid by savings for their old age or for their family and who will suddenly find that the value of their accumulated wealth

has suddenly been reduced to one-fourth of the original value. At the same time as consumers the same people will have to pay higher prices which will be the inevitable consequence of this scheme.

The second benefit which is claimed for this policy is that with the surplus in gold reserves obtained by this artificial means there can be an expansion of credit, an increase in the consumers' purchasing power, and a great encouragement to trade and production of the country. Incidentally this will also solve the problem of unemployment. Of course, all these benefits are to accrue only if the gold surplus value is used prudently under a system of national planning.

The question which must be raised here is whether such drastic devaluation of the currency and the expansion of credit will raise prices to the same extent. It is obvious that if prices rise to the same extent all the benefits will be neutralised by such a rise. The supporters argue from facts of price movements in the past that prices will rise but that this rise can be nowhere near the drastic fall in the value of the currency. There will be some rise in prices and this will be good, in fact necessary, for the expansion of trade and production. By such depreciation of the home currency the cost of home products can be kept down. Thus the country will be able to capture foreign markets in competition with rivals without such advantage of a highly depreciated currency. In this way there will be a fall in prices in these other countries in time to prevent the rise in prices in the home market.

If there is a simultaneous devalution in all the countries of the world there need not be any rise in prices at all. And all countries will thus be able to get rid of their burden of fictitious wealth. Even if only one country adopts this policy it can escape with a small rise in prices which will be good for its production. The rise will be small since in a short time there will be a fall in prices in other countries which will prevent further rise in home prices. With this fall in prices in other countries owing to the loss of markets from competition of the country with devaluated currency these other countries will also be tempted, if not compelled, similarly to devaluate their currencies. Thus the initative by one important country will be sufficient to bring about the operation of the scheme over a much wider area.

Of course, in practice no country has attempted to follow this scheme deliberately to achieve the objects mentioned here. If the scheme ever becomes popular the U. S. A. is obviously the country which can most easily adopt it. It has a huge stock of gold reserves which, from monetary point of view, has been put out of use by the process of sterilization. This gold is not required to support the existing currency and can without difficulty be directed for purposes of credit expansion. But it does not appear that the U.S.A. wants to make this experiment. It may be noted that in the U. S. A. this policy has little support chiefly owing to the writings of the great American economist, Irving Fisher.

(b) Elimination of Gold

There is one scheme which has been suggested for the complete elimination of gold for all currency purposes but which has been partially supported by others as well not for eliminating gold altogether but for supplementing it in the reserves of the country. We shall state the scheme in its extreme form in order to understand its full implications. In that form it wants gold to be altogether eliminated from the monetary standard. At present gold is the final reserve upon which the external value of the currency is based. If the currency appreciates or depreciates as a result of the foreign transactions of the country the corresponding result will be an inflow or outflow of gold, which is attempted to be regulated by a variation in the rates of exchange. But ultimately it is the amount of gold which counts and it is in terms of gold that the value of the currency is determined. The new scheme says that gold should be scrapped altogether from this position and the reserves backing the currency should consist of other commodities. It is argued that social wealth should not in this way be locked up in the form of an article which has little social use. If there is a surplus of gold it has to be sterilized, that is, made useless for all purposes for the time being. Whereas if the reserves consist of some other commodities the surplus can be used as such for purposes of general consumption. Also the distribution of these commodities cannot create such an acute situation as the concentration of gold in a few countries has now done because the production of such commodities will be on a larger scale than that of gold can possibly be. This production or reproduction will prevent their price from increasing as it has done in the

case of gold. Various commodities have been suggested for this purpose. Of course, they must be non-perishable and staple products. Some prefer only raw materials. In this way the favoured commodities are copper, tin, lead—not necessarily one commodity, maybe several commodities at the same time.

The scheme is not impossible although its practicability, especially in the existing conditions of the world, may be doubted. There are many countries in the world which produce such commodities in large quantities and which are debtors to other countries that are industrially more advanced. In many cases these debts are unpaid and cannot be paid except in terms of the commodities which the debtor countries produce. The latter are unable to find a regular market for their products not because the commodities have no use but because the buyer countries have not got sufficient cash. This frozen debt can be liquidated if the new monetary scheme is adopted. The debtor countries will be able to pay and the creditor countries will be able to receive payment in the form of these commodities and use them as reserve backing against their currencies. Of course, this will only apply where a creditor country is highly industrialised and the debtor country produces the raw materials. If both the debtor and creditor countries are industrialised or are importers of the same raw materials, as Britain and Germany or Britain and Italy are, this advantage out of frozen credit cannot be obtained. It is also doubtful whether the scheme can apply to all the creditor countries. Some may not require the commodities produced by their debtors and the latter may find insuperable difficulties in the way of their obtaining sufficient supply from elsewhere to pay off the debts. The most important objection to the scheme is that commodities, whatever their nature, can never have the same ready market for sale in the world market as gold undoubtedly has. At a time of adverse monetary pressure the country must be able at once to pay off a large amount of its current debts to other countries by unloading its reserves. Gold can be so unloaded at any time and in every country without any trouble and without much expense almost to an unlimited extent. This cannot be said of any other commodity. On the contrary at a time of trade depression this unloading of the commodity reserves may be almost impossible and may, through a fall in prices, cause enormous loss to the reserves. Further, it should be noted that the present time is far from ripe when gold can be

dislodged so easily and so effectively from its secure position as the final basis of all monetary reserves. So long as gold enjoys this confidence—and all monetary schemes must ultimately be based on confidence—gold will retain its position for the final liquidation of all debts among the countries of the world.

Some have supported the partial adoption of the scheme in order to strengthen the country's monetary resources by adding commodities to the reserves. This will be in addition to the existing gold reserves. Where the amount of gold is insufficient, as it is in all countries except the U. S. A., commodities may form part of the reserves. This will enable the country holding such mixed reserves to liquidate its foreign demand by selling its stock of commodities when at such a time they have a good market. If the conditions are not favourable the commodities will remain in the reserves and a part of the gold will flow out. In this limited form the scheme is less open to objection, not that the objections are removed but their force becomes less owing to the presence of gold. In other words, the objections are diluted by the dilution of the reserves by the presence of gold.

No country has, in actual practice, attempted to introduce this scheme either in its extreme form or in the limited form of mixed reserves. Theoretically the scheme is not impossible but in the existing conditions of the world and in the presence of the great faith in gold for all monetary purposes the scheme must be declared to be impracticable.

CHAPTER VII

Altering Gold Value of Currency

According to the orthodox view of the functions of money the most important point is to keep the value of the currency stable. This stability has two aspects, *viz.* internal and external. The internal stability depends upon the stability of the value of the currency in terms of commodities within the country ; that is, the level of internal prices must be fairly stable and should not fluctuate much. This means that prices of all articles in terms of the home currency must remain about the same. Wages, cost of living, fixed charges, etc. must continue to be the same. Loan contracts for short and long periods should cease to alter. The external stability can be said to be maintained when the gold parities of different currencies remain the same. Thus the depreciation of another currency must be followed by a corresponding rise in the exchange rate quoted in foreign currency and an appreciation by a corresponding fall. The ideal that is aimed at and that was fairly well maintained up to 1941 is that both the internal and external stability of a currency must be attained. But since 1918 this has been more and more difficult because most of the currencies of the world have no longer a fixed value in terms of gold and keep on varying from time to time, sometimes suddenly and at other times gradually, sometimes as a result of deliberate action on the part of Government and at other times under compulsion of economic circumstances. It is obvious that neither internal nor external stability can be isolated One reacts upon the other through price movements in international trade. When internal prices vary they have a world effect and when world prices vary they have an internal effect.

Owing to the increasing difficulty in adjusting both internal and external variations in prices and the consequent disturbances in both internal and world prices there is a growing volume of opinion that it is impossible to attempt to secure stability in both internal and external prices. Therefore, it is proposed that a futile attempt like

this should be given up and an effort should be made to secure stability of the currency either in terms of internal prices or in terms of other currencies through gold, and at the same time, to devise some fresh method to secure the stability on the other side. The scheme discussed here is one which seeks to stabilise the internal value of the currency and prevent the shock of world prices by altering the gold value of the currency. According to the old system if prices within the country threatened to rise there would be a contraction of currency and credit to neutralise this tendency. Conversely, a tendency towards a fall in prices would be so neutralised by an expansion of currency and credit. This will be quite effective in accordance with the quantity theory of money and with free movement of gold from one country to another.

In this section we shall discuss the scheme which aims at the internal stability of the currency in terms of commodities by a corresponding alteration in its gold value. This scheme was originally adumbrated by Irving Fisher and demands respectful consideration owing to his great eminence as an economist of international reputation. When he wrote in the early twenties of this century the gold dollar was in circulation and therefore he spoke of alteration in the gold content of the dollar. Now there is no gold in circulation anywhere in the world. But his scheme is not on that account made obsolete since it can be equally well applied to paper currencies, provided that they are ultimately linked with gold as most currencies of the world still are. In this form his scheme will aim not at altering the gold content of the currency but the gold equivalent of it. In either case it will be alteration in the gold value of the currency and that is what ultimately counts in determining the external value of the currency

There are two alternative ways by which currency stability can be attained. One is by keeping its gold value constant and by altering its purchasing power in terms of commodities. This is what was done up to 1914 and has been attempted since the termination of the war of 1914-18. Fisher says that for the changed circumstances of the world the better course will now be to adopt as a permanent measure the other alternative. This is to keep constant the purchasing power of the currency and alter its gold value whenever there is a need for adjustment in prices between an individual country and the world. Thus if there is a tendency towards a fall in prices

within a country in response to an alteration in world prices the need will be to prevent this fall from materialising. A change in the internal purchasing power of the currency should not be allowed to come about or if it comes, it should not be allowed to continue. An immediate lowering of the gold value of the currency will be necessary to keep the internal prices steady, that is, at the old level, and at the same time, to counteract the disturbing effect of the alteration in world prices. If the gold value of the currency is reduced the home currency in terms of gold will be depreciated. This will discourage imports from abroad and check the fall in internal prices in response to the fall in world prices. The depreciation of the home currency in terms of foreign currencies would mean the creation of a situation which is equivalent to adverse exchange and will choke off imports to the extent that would be necessary to maintain the level of internal prices in terms of the home currency. In other words, in terms of the home currency with its reduced value in gold, the prices of imported commodities will correspondingly rise within the country and therefore will not tend to bring down internal prices as a result of a fall in world prices.

It is clear that the amount of reduction in the gold value of the currency must exactly correspond to the fall in world prices. If it differs in any way the effect upon internal prices will be to make them fluctuate. Thus if as a result of a fall in world prices to the extent of, say, 10 per cent the reduction in the gold value of the currency is more than 10 per cent, say 15 per cent, this will raise internal prices to the extent of the difference, *viz.* 5 per cent. If, on the other hand, the reduction is less than 10 per cent, say 7 per cent, internal prices will be lower to the extent of the difference, *viz.* 3 per cent. In either case the object will be frustrated since there will be a change in the level of internal prices. Therefore, the reduction in the gold value of the currency must be exactly mathematically—corresponding to the fall in world prices. Fisher says that this can be achieved by a carefully constructed index number of prices within the country so that whenever there is a rise in internal prices the gold value of the currency should be raised and conversely, whenever there is a fall in internal prices the gold value should be lowered exactly in proportion to the alteration in the index number of prices.

There is no doubt that many troubles of a monetary character have in the past arisen as a result of the attempt to maintain the

fixed gold parity of currencies. These were specially evident after 1925 when Britain returned to gold and also during the financial crisis from 1930 onwards. The new scheme does not propose to give up gold altogether. It still wants the value of the currency to be fixed in terms of gold but this gold value is no longer to remain sacrosanct and fixed at one particular point but change continuously, varying according to the variation in internal commodity prices, that is, varying in an inverse ratio to the variations in the internal purchasing power of the currency. If there is an increase in internal commodity prices the gold value of the currency should be proportionately raised and this will bring about a corresponding fall in internal commodity prices. If there is a fall in internal commodity prices the gold value should be proportionately lowered and this will bring about a corresponding rise in internal commodity prices. Thus a system will have been devised which will, so to say, absorb all shocks to internal prices coming from without in the form of changes in the level of world prices.

There are several difficulties which, it is obvious, will have to be surmounted before the scheme can operate successfully and produce the desired result. The first is the construction of the index number of prices. This has always been recognised as a machinery which has numerous defects except when used for measuring only general tendencies in price movements. In fact, if a perfect index number of prices could be devised mankind would long ago have discarded the ordinary monetary standard within the country, especially for contracts over a period of time, in favour of the tabular standard and, in such long period exchange transactions, could be sure of receiving exactly the same exchange value for which a bargain had been originally made. This is not the place to discuss all the defects to be found inherent in the construction of the index number. But a few of these defects which seriously affect the practicability of the use of the index number in the proposed scheme should be mentioned here in order to realise how the suggested remedy, which is expected to operate on the basis of the index number of prices, will fail of its purpose because of the defective nature of the means with which it seeks to operate and because of the frequent changes in the content of the index number itself that will be necessary if it is to retain its accuracy of measurement. It is obvious that such changes

in the content of the index number will make it a different one and therefore it will not be the same as before. It is presumed that the price figures will be those of wholesale prices. But the prices which really affect the general body of people are retail prices. Again, only average prices over the whole country can be taken. Average prices are rarely the actual prices in any one place with which people are directly concerned. Further, if there is a change in the quality of an article there is no means of representing this change in the index number. Again, if there is a change in the relative importance in the articles over a period of time this change also cannot be reflected in the index number. If it is, the basic standard will be wrong. Also individual causes of variation in the prices of articles, especially of basic commodities, may be neutralised by opposite movements of other prices in the index number which will not show this. But any such variation in the prices of basic commodities would surely leave their effects upon the cost of production. Even the corrective, by weightage, in the case of variation in the importance of the different articles in the schedule is not quite satisfactory and may be the subject of controversy. For all these reasons, although the index number of prices may be used for rough and general comparisons between two countries or between two distinct periods of time within the same country, it can hardly be trusted for measuring very small variations in prices or used for changes which may occur within very short periods, say days or weeks or even months. Some supporters of the scheme have realised this difficulty and suggest that the index number of prices in terms of which the gold value of the currency is to be altered should be one of only basic commodities whose price adjustment takes place quickly. This may eliminate some of the foregoing objections but does not remove all of them. On the other hand this innovation creates some fresh difficulties. Thus it will introduce a change in the relative prices of subsidiary commodities, some of which are and some others are not heavily loaded with the prices of basic commodities entering into their costs.

There is also another kind of difficulty which confronts the scheme. In the working of this scheme it has always been assumed —indeed the assumption is necessary for its success—that when the gold value of the currency is altered there will be a corresponding change in internal prices, which will be automatic, immediate, and

uniform for all commodities. It should be noted that the remedy will not be effective nor will the scheme operate in the manner in which it is expected to operate unless this happens. If the adjustment of internal prices takes place through an expansion or contraction of credit which will follow on the consequent depreciation or appreciation of the currency in terms of gold, the scheme will only be a variation of the other scheme of easy credit which we have already discussed. As we have seen there easy credit can be created in a more direct manner than by reducing the gold value of the currency. If the adjustment is to take place by imports adjusting themselves to the desired price level within the country the system only complicates the machinery by altering the gold value of the currency since a direct inflation would serve the purpose equally well. In any case there is little doubt that such adjustment of internal prices cannot be expected to be automatic nor can it operate immediately. This, as is known from long experience of all such changes, will take some time. If the effect is not immediate the purpose of the scheme will be frustrated because during the time lag retail prices of commodities, wages, cost of living, fixed charges, etc. will start changing and will change again after the final adjustment will have come about. Indeed every alteration in the gold value of the currency will bring about such undesirable changes in the long run because of the time that must intervene before the effect of the change in the gold value comes into full operation. A graver dislocation will ensue for another reason. The effect of such an alteration in the currency value cannot be uniform at the same time for the prices of all commodities. Some will respond immediately, others will take time. But the effectiveness of the new policy lies in preventing any such dislocation which can be prevented only when the effect of the alteration upon internal prices is immediate and uniform for all commodities. The final adjustment in the long run may be complete and uniform but in the intervening period there will be disturbances. But the efficacy of the policy is claimed for short periods, in fact its object is to maintain stability of internal prices for all time, short or long. This can be done when all fluctuations in internal prices are completely eliminated, which the proposed scheme fails to do for short periods of time.

If the scheme is to be useful for stabilising prices it should be of universal application and produce the same effects when so applied.

This is also claimed for the scheme. But if the values of all currencies are simultaneously altered in the same direction and to the same extent the internal commodity prices will not change in any way as a result of this policy but continue to do so only for internal reasons. The scheme is expected to operate thus. If the gold value of the currency of one country is reduced the exchange rate will become favourable. Therefore, the prices of the imports into that country, calculated in the home currency, will now proportionately increase. This increase will lead to a direct rise in the home prices of all such commodities produced in the country and of such other commodities also produced in the country as are allied to, connected with, or can be used as substitutes for, the imported commodities. This widespread and general rise in the prices of some commodities will induce a sympathetic rise in the prices of other commodities as well although this sympathetic rise cannot be as great as in the former. But if the gold value of the currencies of all countries move in the same direction and to the same extent the scheme will have no effect at all. In other words, if there is any possibility of international co-operation among the countries of the world for economic purposes, which is highly desirable, the scheme will immediately break down.

Further, we should also note that the scheme contemplates frequent, very frequent, changes in the gold value of a currency. This is highly undesirable It will not only introduce a great element of uncertainty in all business relations in the country whose currency is so altered but would naturally introduce an element of speculation in the normal trade and production, which is always deleterious to the country's economic prosperity. Instead of stabilising things it may introduce too frequent although small variations continuously going on in the country. For long periods of time this scheme may be of some use. In cases of permanent tendencies towards alteration in internal prices this scheme may be found to be of use when adjustment over long periods would be necessary. But for short periods—day to day or week to week fluctuations—the scheme cannot be utilised.

For a brief but momentous period in 1933-34 this policy became very prominent when at the beginning of the first term of President Roosevelt's office it was adopted as the official policy of the Administration. The object for which it was used was not to stabilise internal

prices but to raise them. But the method and procedure remained essentially the same, *viz.* by controlling gold prices and gold stocks in the U. S. A., especially the price of the newly mined gold in the country, in order to lower the gold value of the dollar. From the very beginning the official scheme started with a handicap which does not pertain to the scheme as advocated by its theoretical supporters. The Administration controlled the value of gold in the U.S.A. But the world value of gold could not be controlled nor was the U.S.A. value of gold allowed to be adjusted to its world value by free flow of gold into and out of the country. Thus adjustment in terms of gold had a double meaning which was confusing. In the U. S. A. the dollar was depreciated in terms of gold but gold itself had less value there than elsewhere in the world. Therefore, a particular ratio of the currency to gold meant one thing in the U. S. A. and a different thing in the outside world.

One defect of the scheme became immediately patent. It had been claimed for it that a change in the gold value of the currency would immediately and automatically affect the internal commodity prices. Yet after the gold value of the dollar had been lowered the index number of wholesale prices as also of cost of living showed a fall instead of a rise for several months afterwards. Subsequently there was a rise. But not even after one year did the rise in commodity prices become proportionate to the fall in the gold value of dollar. In fact, the two never corresponded, the former always lagging behind. The policy was given up in 1934 and the value of the dollar was fixed in terms of gold at 41 per cent of its original gold parity.

In Britain the scheme was never officially or even consciously adopted. But from 1931 when the sterling link to gold was severed there was a sort of breakdown in the system, which in its actual operation closely approximated to the scheme of deliberately altering the gold value of the currency. This was due to the fact that, unlike other countries whose currencies went off gold, in Britain there was no ban on converting the sterling into gold although officially the authorities would not consider the paper currency convertible into gold nor fix any rate for such conversion. But gold was sold freely in the open market and was allowed to be sold practically to an unlimited extent. Therefore, there was a value fixed in the market between the sterling and gold according to its demand and supply. As for some time

the sterling went on depreciating from 1931 the situation was as if the gold value of the sterling was being reduced from time to time as contemplated in the scheme under consideration. This could be so because the supply of gold in the British market never fell short of all demands that were made upon it. Thus this peculiar feature of actual convertibility of the sterling into gold to an unlimited extent through the open market in spite of the official severance of the sterling from gold made the "breakdown" system the same in effect as the scheme of systematic reduction of the gold value of the currency.

It would be wrong to assume that the gold value of the sterling was getting reduced, in a haphazard manner, consequent on the operations in the free market for gold. There was certainly official intervention continuously exerted through the Exchange Equalisation Account. There was of course no official policy behind this intervention whether to raise or to lower prices. The object was probably a vague one of not allowing the sterling to depreciate too suddenly or too excessively in terms of gold. Probably also there was an equally vague idea to try to conserve gold even when its market remained free and open, which latter was done in order to keep up confidence; in this respect Government intervention was eminently successful. But at the same time it is evident that every fall in the gold value of the sterling did prevent a fall in internal prices by continually and steadily bolstering up the forces in favour of a rise. This operation practically ceased from 1935, especially after the dollar had been stabilised in terms of gold, and the gold value of the sterling has since then remained practically unaltered. Of course, the scheme of reducing the gold value of the currency was never adopted as a policy nor even acknowledged as one of the objects of Government intervention.

Several variants of the Fisher scheme have been advocated by many others. In spite of the critisim of the scheme it will be seen that in practice many countries of the world have been compelled to alter the gold value of their currencies either because they were compelled to do so owing to the exhaustion of their gold reserves or because economic circumstances, especially in their relation with countries which had so altered their currency value, made it desirable to do so. Fisher's scheme is very comprehensive and aspires to cover at the same time all contingencies, whether over long or short periods, whether the causes are temporary or permanent. It is evident that

temporary causes under the scheme will require frequent and short-period changes in the gold value of the currency and that permanent and lasting causes will require occasional adjustment after a fairly long period of time. From these considerations an attempt has been made to develop two separate schemes, one with frequent changes and the other with only occasional changes.

Keynes has advocated the former scheme. This has really arisen out of the necessity to conserve the gold reserves of a country, which, in the existing condition of the currency link with gold, must be conserved in order to maintain the international value of the currency. Normally gold moves from one country to another when the gold point —export or import—has been reached. The gold points are determined by the cost of transporting gold from one country to another and by the facility with which gold can be obtained in a country. If the latter is restricted in a country the gold value of the currency of that country will fall. This will really lead to a breakdown of the currency. Therefore, such depreciation of a currency must be eliminated in order to maintain a stable value of the currency. But too frequent movements of gold from one country to another, especially for temporary purposes, also unsettle internal prices. Such movements tend to increase with the narrowing of the difference between the gold export and import points, that is, by a reduction in the cost of transporting gold from one country to another. This has happened as a result of regular air services in the world. Gold being an article with high value in small bulk and air transport being very quick the cost of transporting gold by air has been substantially less than the cost of transporting it by other means. Also the time taken for transporting it being less there tends to be more frequent movements of gold. Causes which formerly would have been considered too temporary to justify or pay for gold transport now lead to it by air services. Thus a new element of disturbance through too frequent movements of gold has been introduced into monetary fluctuations by the narrowing down of the difference between the gold export and import points. Such frequent movements of gold for purely temporary causes and for causes which in most cases reverse the process within a short time have an unsettling effect upon the normal trade between two countries. Therefore, in order to limit such movements Keynes suggests that the difference between the gold export and import points should be widened. This scheme would be one of monetary reform because it

seeks not merely to correct the narrowing of the difference beween the gold points introduced by quicker means of transportation but to make it much wider than what it was in the old days. Even formerly the difference was only a fraction of one per cent whereas Keynes' proposal is to make it beween 2½ and 3 per cent. This is to be done by the central bank's quotation for gold. Its selling price should be higher than its buying price by this amount and not as previously by double the amount of the cost of transporting gold. It is obvious that at times of adverse exchange this policy will, by discouraging the export of gold, depress its value within the country up to 2½ or 3 per cent. Therefore, to this extent the home currency will be depreciated and the results claimed by the Fisher scheme, so far as a tendency operating upon internal commodity prices is concerned, will be in operation. It is argued that this scheme will eliminate the adverse effects of the Fisher scheme for several reasons. The maximum possible depreciation being only three per cent the dislocation in commodity prices will be negligible, if at all felt. The amount of depreciation, being definitely known from the central bank's policy, will not lead to any undesirable speculation which is likely to arise in cases of uncertainty as to the central bank's policy. Also the scheme obviates the necessity of maintaining a standard form of index number of prices in terms of which the Fisher scheme contemplates the alteration in the gold value of the currency. There is no doubt that Keynes' proposal will be effective in counteracting movements of gold owing to seasonal influences or to arbitrage operations. In fact, he suggests this scheme along with his scheme for dealing in forward exchange by central banks for this purpose only. These two together are expected to supplant the former method of altering the spot rate of interest which has other disturbing effects, especially upon internal commodity prices.

But this scheme cannot be useful, Keynes does not claim that it will be useful, when owing to lasting and permanent causes there is an export of gold, particularly when there is a flight of the currency away from gold. In such cases confidence in the currency is shaken and therefore any attempt on the part of the central bank to discourage the export of gold by raising its selling price will only further shake confidence and lead to greater exports of gold. The supporters of the second variant of the Fisher scheme say that at such time the gold parity of the currency should be permanently

altered because such alteration would be justified by the permanent changes in the economic conditions of the country. Such a situation will arise when the disparity in the economic condition of two countries has become so great that one country tends to have a permanent adverse exchange if the original gold value of its currency is retained. Such alteration in the gold value is expected to be much less frequent since permanent economic conditions take a long time to be changed in favour of or against a country's foreign trade. Such alterations have been made by almost every country in the world since the termination of the war of 1914-18 although no country has so far deliberately accepted the policy advocated by the supporters of this scheme.

CHAPTER VIII

Deflation

Before dealing with the scheme of altering the gold value of the currency we discussed two opposite schools of opinion. Fisher attempts to keep intact the internal value of the currency and vary the external value for the purpose of maintaining the stability of internal prices. The orthodox school has always attempted to keep intact the external, that is, gold, value of the currency and vary the internal value in order to adjust any change in world prices. The scheme which we shall discuss now is the one which has been developed by the supporters of the orthodox school. The problem arose in an acute manner at the time of the last financial crisis when world prices were falling. At that stage the problem was how to keep intact the gold value of the currency and at the same time prevent the fall in internal prices. Before 1914 when most of the currencies of the world were actually gold coins it was not considered necessary for Government to take any action and what may be called the automatic system operated. As soon as there was a maladjustment between internal and world prices movement of gold would automatically start and set up a corrective for the loss of equilibrium. If the level of internal prices was lower than the world level exports would increase and the consequent favourable exchange rate would reach the gold import point and induce a flow of gold into the country. This would expand currency and credit within the country, thus raising the level of internal prices. If, on the other hand, the level of internal prices was higher than the world level imports would increase and the consequent adverse exchange rate would reach the gold export point and induce a flow of gold out of the country. This would contract currency and credit within the country, thus lowering the level of internal prices. The scheme of deflation discussed here wants to give up the policy of haphazard deflation or inflation and introduce Government intervention in order to make the effect steady and uniform while maintaining the gold

value of the currency in the face of a fall or rise in world prices. During the last crisis world prices were falling. Therefore, the actual problem in most of the countries was how to adjust the high internal prices to the low world prices. In other words, deflation was what was required. We shall therefore discuss deflation as the problem to be tackled under this scheme although the arguments would equally well apply to the case for inflation.

The defect of the old automatic system is that deflation—contraction of currency and credit—takes place by an outflow of gold, leaving its effects upon internal prices to be adjusted automatically. This adjustment is difficult because all prices do not respond to the same extent. Some prices will immediately fall, others will take time. Wages, cost of living, fixed charges, loan contracts, etc. take a long time before they are adjusted to the deflation which has taken place. Therefore, during the interval the cost of production per unit remains high since wages and fixed charges remain unaltered. This prevents a fall in internal prices and certainly works unfairly since some prices fall and others do not. The purpose of the new scheme is to bring about a fall in all internal prices simultaneously and to the same extent If this can be done all hardships will be removed since the relative prices will remain the same. The scheme therefore is not to allow the deflation to take its own course as under the orthodox scheme but to introduce effective Government intervention in enforcing an immediate fall in internal prices corresponding to the extent of the desired deflation. This controlled deflation is expected to remove the defects of the older system of uncontrolled deflation.

At the outset it should be noted that this will necessarily involve wide and detailed interference with the economic life of the people of the country. When there has been a fall in world prices and the country has, in response to that, had the desired contraction of credit some prices will be immediately affected. In order to make the fall in internal prices uniform Government must intervene and order a fall in prices in all directions and see that every item within the country has had a corresponding fall. There are several important items which take some time to move. Government intervention must be made immediately effective in regard to these items. Thus Government must order an immediate fall in wages throughout the country, not merely of its own employees but of all employees

within the country including those in private business units as well. The prices of all commodities must come under control and be immediately reduced, thus establishing full Government control in regulating all prices. Fixed charges including rent charges and other charges arranged in advance by private contracts must be similarly reduced. All public and private contracts for loans will be affected; this will have the effect of compulsory conversion of loans into those with reduced interest rates. Even assuming that this will be possible it is doubtful whether this Government intervention with every detail of the economic life of the people will be tolerated by the public. There is bound to be grave discontent and serious opposition and the political repercussions may be too wide and deep for such interference to be continued as a permanent policy. In a word, economic freedom of the individual must be completely surrendered.

A second objection to the scheme is that its adoption as a policy will introduce too frequent changes in internal prices. Every time that there is a change in world prices the internal prices must be altered by Government intervention. This is bound to be frequent, maybe even daily or weekly changes. All calculations regarding expenditure in business and for consumption are bound to be upset and it will be impossible for business people and consumers to make any plan about the future. Such uncertainty and instability will probably cause greater hardship than any injustice due to the existing system of haphazard deflation and automatic adjustment, however gradual it may be.

Another objection is regarding the practicability of Government or any public body to interfere with the economic details of a country's life in so comprehensive a manner as to be able to maintain the exact correspondence in the movement of internal prices in response to world prices. Very small prices will be difficult to adjust completely and if attempted, may lead to absurd fractions in terms of the currency. If this is done broadly there may be grave injustice to the consumers, especially the poorer among them in whose list of expenditure such articles may be found to be quite important items of consumption. If Government decide to intervene only when world prices have fallen to an appreciable extent there will arise a time interval between such fall and the adjustment of internal prices. During this period all the

evils of uncontrolled deflation will arise, which it is the purpose of the scheme to eliminate. In other words, this will only lead to a breakdown of the scheme. Therefore, in order to make it effective such intervention must come as soon as there has been a fall in world prices.

It is highly doubtful whether the main purpose for which practical statesmen adopted this scheme out of necessity, especially in the gold *bloc* countries, could be served in the specific cases in which it was adopted. The immediate object was to balance the Government budget. The cuts in salaries in the budget had to be heavy and in order to compensate for this the cost of living had to be reduced by deflation accompanied with Government interference with internal prices. But owing to strong opposition and extensive evasion the cost of living never fell in the same proportion as the cuts in salaries. If internal prices were to be adjusted to world prices these cuts had to be renewed several times while the cost of living did not fall in the same proportion. Also in the result there was a drastic fall in Government revenue. This further created budget deficits, to make up for which more and more cuts were indicated.

Further, it may be remarked that if internal prices are made to fall to the desired extent it is not sufficient to reduce interest rates on loans. If the principal amounts remain the same the debtors, at the time of repayment or renewal of loans, will find that they have to give a larger sum in wealth than before because, owing to the fall in prices, the purchasing of power of money in terms of which the original loans had been contracted has risen in the meantime. Therefore, in order to make the scheme effective and in order to maintain fair and just relations between the lender and the borrower, Government must not only intervene and order a fall in the interest rate but must also interfere with existing loan contracts and reduce their principal amounts. This will be an intolerable interference with private contracts and will have to be done every time that there is a fall in world prices and the consequent deflation.

Again, it should be noted that the scheme is liable to be utilised for non-monetary purposes which its orthodox supporters will look upon with horror. This scheme has been mainly the outcome of a breakdown during the last financial crisis and was sponsored by the orthodox monetary circles purely as a practical measure without much theoretical support. They thought—wrongly

of course—that it was the minimum change from the gold standard as it was expected to keep intact the gold link of the currency. But in their devotion to the system of gold standard they have landed themselves to supporting a scheme which implies grave and detailed interference with economic freedom. They appear to be blind to everything else if they can maintain the gold parity of the currency. But there are others who have lent their support to the scheme not because they want a scheme for purely monetary reform but because they find it to be a useful instrument to introduce economic reforms of a far-reaching character. Extreme radicals support the scheme because the extensive regulation of all prices in detail will give a Socialist Government sufficient power to alter and regulate prices in such a way as to bring about a redistribution of wealth within the country. This can be done by reducing internal prices of articles of general consumption more rapidly than the fall in world prices. Rents and other fixed charges can be made to fall also in the same manner. At the same time wages may be kept up at a higher level or not allowed to fall at all. All these results will be of a non-monetary nature and therefore they are outside the scope of our discussions. But their possibility must be envisaged while advocating the scheme as one of purely monetary reform.

In practice the scheme was succssfully adopted for a few years in one country and unsuccessfully in another. In Italy such cuts were introduced twice, in 1931 and 1934, by the Fascist Government. All opposition was crushed. This was not difficult as all labour strikes had been declared illegal. In spite of the expansion of armament industries the bank rate was never raised, in fact it was lowered in 1934. It is doubtful whether such result would ensue in a country which did not have an authoritarian system of Government as there exists in Italy. The scheme was also tried in France in 1935. Government by decrees reduced the cost of living and ordered a lower rate of interest on all Government and several big private loans. Persistent opposition followed and strikes were widespread, so that the danger to a reduction of wealth was so great that there was little chance of realising sufficient revenue to balance the budget. In any case the result in France was not encouraging. In Holland and Belgium the adoption of the scheme raised violent opposition and was scotched almost before it had been adopted.

In the U. S. A. an effort was made in the opposite direction. We have so long been speaking of the fall in world prices. It should be remembered that this fall began in the U. S. A. with the financial crisis which started there in 1929. There the problem was how to raise prices which had been falling. Therefore, the application of the scheme under consideration would be the reverse of that in Europe where the problem was to reduce internal prices. In the scheme thus adopted in the U.S.A. the attempt was made to have reflation instead of deflation and thereby raise wages. The attempt was frustrated by the opposition of big business to raise wages at a time when business was collapsing and by the attempt on the part of the debtors to force upon the Administration a policy of inflation. Finally, the scheme had to be abandoned owing to a defect in legislation and a decree of the Supreme Court.

CHAPTER IX

Dual Currency

In attempting to have internal prices adjusted to world prices a third method, which we mentioned while discussing the alternatives under altering the gold value of a currency, has been suggested. This however has little theoretical support and was the result of the breakdown of the currency system, which was widespread in the twenties of this century. This scheme consists of having two entirely different currencies for one country, one for internal exchange and the other for external or foreign payments. The former will consist of inconvertible paper and the latter will be linked with gold. The relative value of the two currencies will keep on varying and it is expected that this fluctuation will help the stability of internal and world prices. If the internal currency depreciates in terms of the external currency the prices of exported articles in terms of the latter will remain the same even though internal prices in terms of the former have increased. As we shall see later this purpose can be better served by what is called the controlled or managed currency and what was adopted in India even before the war of 1914-18 under the name of the gold exchange standard.

A second scheme under dual currency is to have one currency for short periods and another for long periods of time. The latter will have a stable value while the former will be deliberately depreciated for purposes of stimulating productive enterprise. The short-period money will be penalised by means of a negative interest rate. The long-period money will be stable and have no alteration in its value. This is to be achieved by various means. According to some advocates the long-period money is to be permanently linked with gold. Others advocate the link in terms of the cost of living. Others again want it in terms of commodities. In the two latter cases the adjustment will have to be made by means of an index number of prices or cost of living. All the defects connected with index numbers will appear in such cases and the schemes cannot be as

useful as the advocates imagine. Another defect lies in the presumption, which is incorrect, that when there is a change in the prices of some commodities in terms of the long-period money corresponding and uniform changes will immediately follow in all other prices. If this is not so, the stability of prices in terms of the long-period money will not be maintained. A third defect is that if prices in terms of the long-period money remain stable and those in terms of the short-period money fluctuate there will, in all cases of wide substantial amount of unearned profits or unforeseen losses. Such a differences, appear a situation, instead of stabilising the economic condition of a country, will only introduce unhealthy speculation into the normal trade and production of that country.

In practice the scheme of dual currency was adopted only in two countries, *viz.* the U.S.A. and Germany. In the U.S.A. the scheme was adopted as far back as the sixties of the last century. After the Civil War the greenbacks were so depreciated that in all contracts for loans it was customary to introduce a clause according to which debtors were to repay their debts in terms of gold dollars which existed at the time. This scheme had no practical effect since very soon the dollar regained its gold parity and remained so till the thirties of the present century. When the Administration in the first term of President Roosevelt's regime wanted deliberately to depreciate the dollar in terms of gold in order to put the New Deal upon a successful footing this provision of the sixties of the last century threatened to undermine the policy underlying the New Deal. For if the fresh loan contracts could be made in terms of gold the policy of depreciating the dollar in terms of gold would be frustrated since all loan contracts, in view of the deliberate depreciation, might be made in terms of gold. The matter was taken up to the Supreme Court which declared the old gold clause to be invalid in law. Thus this clause was eliminated from all contracts. It is evident therefore that the system worked well so long as the dollar did not depreciate and broke down when it did in fact depreciate

In Germany the scheme of dual currency was deliberately adopted but only as a temporary measure in order to pave the way of transition from demonetisation of the highly depreciated paper mark to the establishment of the new permanent currency, *viz.* reichsmark. In the interval the rentenmark was introduced for a short time. It circulated simultaneously with the old mark. The rentenmark was

kept stable in value. Thus the level of prices in terms of this money remained stable while it sharply rose in terms of the old mark. Therefore, the rentenmark appreciated in terms of the old mark which was depreciating. In this way there was in actual practice two currencies, the old mark and the rentenmark, the one fluctuating and the other stable in value. This stability in internal prices in terms of the rentenmark re-established public confidence in money, which had been rudely shattered in the previous period, and paved the way to the introduction of the reichsmark, the present currency. When the reichsmark was introduced it supplanted both the old mark and the rentenmark and the country reverted to the normal system of one currency. This method was also followed in a few other countries of eastern Europe in which the original currency had depreciated beyond repair.

For a brief period the same system re-appeared in Germany when after the moratorium in the last financial crisis funds accumulated in the form of blocked foreign accounts. These depreciated in terms of the reichsmark. Thus there were virtually two currencies, the former depreciated and the latter not so. This brought some advantages to the country in foreign trade since the internal prices remained stable in terms of the reichsmark while the value of exports in terms of the depreciated blocked foreign accounts fell, thus keeping up the flow of exports. But this could not last long nor could this be pursued as a permanent policy after the blocked foreign accounts were exhausted. This system in Germany was also followed in a few other countries of eastern Europe.

CHAPTER X

Purely National Currency

Among the various schools of opinion advocating monetary reform after the war of 1914-18 two divergent schools have developed two different types of schemes which are wholly opposed to each other. It will be remembered that most monetary troubles have arisen because of the difficulty which arises from the fact that in the post-war period most of the currencies of the world have gone off gold and therefore their relative values, that is, in foreign exchange, have become uncertain, fluctuating sometimes beyond all anticipated limits and controlled frequently by Government. This brings about movements in the level of world prices which are different from the level of internal prices in any one country. Therefore, the main problem is to adjust internal prices to those of the world without upsetting internal economic balance which exists at any particular time and which it may be considered desirable to maintain in the economic interests of the country concerned. The two schools of opinion to which we refer attempt to do away with currency anomalies by two entirely different and opposed schemes. One scheme is not to have more than one currency in the world. It wants to have a world currency which will be the standard money of all countries. We shall have occasion to discuss this scheme in detail towards the end of this treatise. Here we shall discuss the other scheme which wants to do away with currency anomalies by severing altogether the internal currency from any connection with all other currencies of the world.

According to this scheme the currency will be inconvertible in terms of gold or of other currencies. It will be a purely national currency used within the country and in terms of which internal prices will be regulated. It or the credit based upon it will be completely isolated and there will be no foreign trade in terms of this currency. The advocates of this scheme argue that at present there is too much jealousy among the countries of the world to permit any

common policy to be adopted by all or even any co-operation except to the advantage of some and the detriment of others. Therefore, it is unwise to try to develop any system in which all countries can voluntarily seek shelter from the currency chaos which every now and then threatens them. Also it has been seen that in any co-operative system trouble arises whenever a fresh adjustment is required by any country when its internal price level becomes different from the world level. At such times a country that is weak is unable or unwilling to keep to the system and thus may be a source of trouble to all the others, especially to those with which it has business connections or of whose products its industries are rivals in a neutral market. The same thing may happen if a country is inefficient in managing its currency or if it obstinately refuses to lend its support to a policy adopted by the others. If, therefore, a scheme can be devised which will wholly and completely dissociate the level of internal prices from that of world prices so that the latter will have no effect whatsoever upon the former the country thus adopting the new policy can be free to proceed with its own economic development according to its own plan without being interfered with or obstructed by the price changes which may take place in other countries. It is said that this can be effectively done by having a currency for the country, which will be regulated purely by its national interests without being affected in any way by what is happening in other countries. This complete severance of the national currency from the rest of the world will bring about certain revolutionary changes in the methods of exchange operations which have long persisted and to retain which most countries have striven in the past and are striving even now. For example, the new currency not having any connection with gold or any other currencies, there can be no foreign exchange market. So far as this currency is concerned it will have no value in terms of other currencies. It will only have internal value in terms of commodities which will form subjects of exchange transactions within the country. If the foreign exchange system is thus abolished there will be no such thing as an exchange rate between this country and the rest of the world; therefore, there will be neither a spot rate of interest nor a forward exchange rate. All speculative and arbitrage transactions will cease. The highly disturbing factors connected with the transfer of foreign holdings will be abolished. Transfer of accounts will be impossible because

the currency of this country will have no value in terms of any foreign currency. There will be no reserve of gold necessary to maintain and regulate the value of the currency for purposes of foreign trade.

This scheme is based on the supposition that the country will simultaneously have planned economy of a totalitarian type and that this planning will be well conceived and efficiently carried through. The production of all major industries will be properly directed and the productive factors of the country will be distributed among them in such a way that no industry will suffer from lack of such factors nor will any industry have too much. The distribution of these factors will be according to the needs of the country for purposes of production as also the special facilities that the country may possess in developing particular types of industries. Thus a country will develop an industry if raw materials for such an industry can be easily obtained. Or, the country may have the full benefit of technical inventions which may be applied to its industries without the disturbing element of foreign rivalry or of internal maladjustment in adequate help. If efficient methods of production have been devised these will have opportunity of being fully exploited for the economic development of the country. This system will vastly increase the wealth produced in the country because of the full scope given to natural facilities in raw materials, expert labour, technical inventions, efficient methods of production, and a well ordered plan of economic progress. If simultaneously there is adopted within the country the policy of moderate but continuous expansion of currency and credit the encouragement to wealth production will both be great and be directed along the proper channels. Prices will rise gradually and almost continuously. It may be remembered that such a moderate but continuous rise in prices was, under the old system of free trade and production, considered to be ideal for the economic prosperty of the world which, for all such purposes, used to be taken as one unit. Normally the rise in internal prices brought about in this manner would immediately start a reaction, for the market of this country now would be a better one in which to sell and all the countries with a lower price level will be encouraged to send their products here. Thus the country's imports will increase and exports diminish, thereby creating an adverse balance of trade, which must

be ultimately neutralised by an out-flow of gold or foreign holdings which will bring about a contraction of currency and credit and therefore a fall in the level of internal prices. But under the new scheme there is no such connection between the internal currency and gold or any other currencies, nor any gold reserve or foreign holdings behind the currency. Nor is there any free flow of goods into and out of the country. Therefore, it is expected that the continuous progress in wealth production will be maintained and this will help the country to raise its general standard of living almost to an unlimited extent. Social amelioration of present conditions will be possible in a number of ways. Big housing schemes may be undertaken out of this additional wealth. Roads and other works of general utility can be financed and carried through. As a result unemployment will be reduced or eliminated.

From this it should not be concluded that all foreign trade must also cease and that the country will be wholly cut off from the world in its economic life. There will be foreign trade but not through any currency but purely by barter. Government control will be effective in regard to all foreign trade. Government will decide upon the commodities which will be imported and exported and thus become the subject of international trade. Such exports will be essentially equivalent to exports in value which will be the subject of direct negotiation between the two countries or even between the traders of the two countries. This negotiated exchange value will have nothing to do with money or its equivalent but will be determined purely in terms of the commodities which will be exchanged between the two countries. That is, so far as international trade is concerned it will take the form of unmixed barter assuming that no money exists for such purposes. The argument is that imports will be strictly regulated according to the needs of the country and will be confined only to those commodities which cannot be easily produced in the country and which will be considered essential for the country's prosperity. Such imports will be paid for by exports which will be produced deliberately in excess of the needs of the country for this specific purpose. If necessary—and the advocates of the scheme contemplate such necessity — the production of exports will be subsidised by Government or a bounty on exports offered to their producers in order to enable them to sell at the prices prevalent in foreign markets, such prices to be calculated in terms of the

currency of such markets. The increase in general wealth is expected to be so great that as compared with that, the amount of the subsidy or bounty which will have to be paid will be small and will be easily borne by the country. The foreign trade of a country may be very necessary. But its amount in proportion to the internal wealth is always small, even in the case of a small but highly developed country. In all cases the importance of foreign trade, especially for exports, is to keep up a higher margin for prices in the wider market and this margin stimulates production within the country. But the quantity of such exports is always a fraction only of the total wealth production of the country. If that is so, even a comparatively heavy subsidy or bounty on the production or trade of the exported commodities can only be a fraction of the total wealth. If the latter continuously increases in all directions—as it is claimed for the scheme—the country will be able easily to pay for the loss by way of a subsidy or bounty. It should be noted that this loss is in terms of cost of production of the exported commodities. That is, the loss will appear on a comparison between the prices of the imported and exported commodities in the foreign country in which the former are to be purchased and the latter to be sold. But this loss will not necessarily reflect the actual loss to the country. It may be—and it is expected to be—actually a gain in utility. If the imported commodities are properly chosen they will be such as cannot be easily produced in the country and are yet of great utility as articles of general consumption or basic commodities which are essential for the production of other goods of great public utility. Therefore, from their very nature they will be commodities whose value in terms of usefulness or welfare to the country must be adjudged very highly. On the other hand, if the articles which will be required to pay for the imported articles are also properly selected they will be such articles in the production of which the country has special facilities or advantages in the form of cheap or high grade raw materials, expert labour, technical inventions, efficient methods of production, and sufficient capital. If this is so, the cost of producing these articles in terms of real sacrifices will be small and their marginal utility will be low. Thus in terms of consumption value or utility the exported commodities will rank low while that of the imported commodities will be high. Therefore, although it may be necessary to pay a subsidy or bounty to the exported commodities the foreign trade, regulated and directed under

the proposed scheme, may be so organised that in terms of usefulness or welfare to the country the value of the imports will be higher than that of the exports. Even if this is not so and in the balance there is a certain amount of loss in the transaction this amount will be a small fraction of the total increase in internal wealth which will be the result of the new scheme.

Thus we see that the scheme. though crude in some respects and cretainly repugnant to all current ideas of wide and intimate relations among the countries of the world, has a good deal of theoretical justification to support it. There are of course several non-monetary, even non-economic, arguments against the scheme and these should not detain us here. From the purely monetary point of view there are two objections to the scheme. One is about planned economy. The assumption throughout the arguments in favour of the case has been that planning will be adequate and effective and will be efficiently executed. We have already discussed, this point in another connection and have seen that as yet no country has been able to develop such a comprehensive system of totalitarian planning nor is it likely that in the near future this will be achieved in any country to an adequate extent. Also it is highly doubtful whether even a workable system of such planning can be conceived and put into effective operation without a corresponding system of authoritarian Government which will have sufficient power to enforce it in actual practice. The second objection arises out of the first. Obviously the new scheme will require Government control in almost every department of economic activity of the country. Productive factors cannot be properly distributed among the various industries of the country without a definite plan of action on the part of Government. This plan must take into account and finally decide what should be the goods to be consumed by the people, what commodities would be of general utility, and what funds must be diverted for the purpose. Such totalitarian control over the economic life of the people must have as its aim some reform in the distribution of wealth among the members of the community if it is not to meet with violent opposition. It is doubtful whether any satisfactory scheme of reform in the distribution of wealth among the various classes of the people of a country has yet been devised. The Socialist criticism of the present system of distribution may, to a large extent, be valid but no reform has so far been suggested

which, in the eyes of the general body of the people, can be said to be adequate and which yet leaves the great motive of individual initative and enterprise unimpaired. Further, the economic interference will not only be comprehensive for internal production and distribution of wealth but also extend to external trade and to creation, supply, and distribution of the currency and credit of the country.

In practice this scheme of currency for purely national purposes has been adopted in two countries both of which have Government with dictatorial powers, *viz.* Russia and Germany. In Russia the movement started in favour of the abolition of all currency which was considered to be the symbol and support of Capitalism. But as it was found impossible to do so the currency was stabilised for purposes of internal exchange. Internal prices had no connection with world prices. There was no exchange rate between the Russian currency and other currencies of the world nor was it quoted in terms of gold. Yet Russia had an extensive foreign trade which was carried on purely by barter and the exchange value of its exported commodities depended entirely upon the country's need for obtaining the imported commodities. For a time a sort of connection was kept up with the financial centres of the world by the export of Russian bank-notes. This also permitted the flight of capital out of Russia. Very soon this was also stopped by prohibiting the export or import of such notes, thus confining the use of the currency within the country. It is claimed that this system accompanied with the continued and steady depreciation of the currency has helped Russia successfully to carry through its Five-year Plans, that the home market has been immune from the effects of fluctuations in world prices, and that the flight of capital has been effectively prevented. There is no doubt that to a large extent such claims are valid although it is difficult to check details owing to lack of sufficient data regarding Russia's economic life.

In Germany the scheme was not introduced deliberately as in Russia. The idea was to prevent a monetary debacle which threatened to follow the depreciation of the currency and to prevent the consequent flight of capital. With this limited object in view all foreign exchange transactions were rigidly controlled. The rise in internal prices thus caused encouraged an era of industrial expansion. This was vastly increased by the Government scheme of rearmament which, as part of planned economy, was adopted in 1933 almost

immediately after the Nazis came into power. This rise in internal prices was altogether divorced from the movement in world prices and under any normal system, would have created an adverse exchange which would have resulted in a flight of capital out of the country. Therefore, full Government control in the form of planned economy had to be introduced in order to eliminate the effects of this adverse exchange and the necessary control over all foreign trade including transfer of funds was effectively introduced. As a result of the collapse of the gold *bloc* sponsored by France more countries might have been tempted to cut off their currencies from those of the rest of the world and it would have been an interesting experiment for study on the part of the student of monetary reform. The present war has deprived him of that opportunity by introducing other elements which have had more serious consequences upon the national economy of all the European countries.

CHAPTER XI

Bimetallism

Before we pass on to the consideration of the antithesis of the purely national currency, *viz.* an international currency, we have to discuss two other schemes which may be said to be intermediate between the purely national and absolutely international currencies because those two schemes indicate some sort of international co-operation for their maintenance. The one is the system of bimetallism and the other is the system of managed currency which is controlled in both its internal and its external value.

Bimetallism is not a new scheme but one which was developed out of some form or other in which it had existed in many countries. In its present form the scheme may be said specially to have grown since the latter half of thc nineteenth century. Although circumstances were too strong for its retention at the time it has never been altogether abandoned and it has always had its theoretical supporters in several countries of the world. It is no wonder that, in the period after the war of 1914-18 when a large variety of proposals for currency reform were being made in many quarters, bimetallism would also be advocated The present times are different and it is only to be expected that the supporters of this scheme will also adjust it to the circumstances of the time. Thus we find a few suggestions which are new in the system as it was developed and accepted in the nineteenth century. As developed at that time and as it was supposed to have been perfected then the system of bimetallism was not merely that coins of two different metals—usually gold and silver—should be in circulation in the country. Bimetallism was said to be in operation when four conditions were satisfied. At that time it was really a variation—a simplification—of what was known as the system of multiple legal tender. This system insisted on the conditions that there must be in circulation coins of two or more metals, that both the coins must be full legal tender, that both must be freely coined, that is, anybody would have the right to present

bullion in an unlimited quantity and get in return coins of that metal, and that the relative value of the two kinds of coins must be fixed by law. The system, thus conceived, differs from the system of parallel standard because the relative money value of the coins of the different metals is determined by law. It differs from the system of composite legal tender because there is more than one metal the coins of which are full legal tender. It differs from the system called the gold exchange or bullion standard because all the metals have free coinage. In this system of multiple legal tender when there are coins of only two metals it is called bimetallism. When there are more than two metals it would be called poly-metallism.

Bimetallism has two distinct series of results when it is national, that is, when it is confined to one or a few countries, and when it is international, that is, when it is adopted by all or a large number of countries of the world. If it is national it is difficult or impossible to maintain it as bimetallism, for it quickly degenerates into an alternating system in which the coins of either the one metal or the other remain in circulation and the other disappears. This is due to the operation of Gresham's law. If we assume that gold and silver are the two metals in use and if, as it must happen, the ratio between the two metals fixed by law is different at any time from the relative value of gold and silver in the world market, one of the metals will be depreciated as metal and the other as money. The latter will be driven out of circulation and coins in the former will only remain in circulation. If the relative value of gold and silver is reversed the first metal will be driven out of circulation and the other metal will come in. Thus the system tends to become an alternating standard, sometimes one metal being used as money and sometimes the other according as the relative value of one or the other metal goes down in value. The reason for this state of things is that there may be two different values of the two coins, one as money and the other as metal. The former is determined by the law of the bimetallic country and the latter by the conditions of demand and supply of the two metals in the world market. This cannot be prevented in the case of national bimetallism, that is, in the case when one or a few countries adopt bimetallism. But if all or a large number of countries of the world combine together in having the bimetallic system, that is, if there is international bimetallism,

then there is an automatic check to the operation of Gresham's law by the counter-operation of another law, *viz.* the law of compensatory action. In international bimetallism all or most of the countries of the world will fix by law the relative value of the two coins as money. Their relative value as metal will also be fixed in the bullion market of the same world. In this case, when there is variation in the two values, that is, as money and metal, of gold and silver there is a corrective which works automatically through the open mint. If silver as metal depreciates and gold as metal appreciates—which is the same thing as silver appreciating and gold depreciating as money—silver coins will be minted into currency and gold coins melted into bullion. This process will go on all over the world on an extensive scale, all or most of the countries having bimetallism. But this will lead to a great increase in the demand for silver to be used as money, thus substantially reducing the supply of silver as metal. On the other hand, by the melting of gold coins the supply of gold bullion will substantially increase. Thus the diminished supply of silver as metal and the increased supply of gold as metal will raise the value of silver in terms of gold. Therefore, the former depreciation of silver and appreciation of gold, which started the process of minting silver and melting gold, will be corrected. This process of correction will continue till the relative value of gold and silver as bullion is brought back to the same position as their relative value as coins. This is known as the compensatory action of international bimetallism. This does not operate in national bimetallism because the additional demand of the depreciated metal for purposes of minting and the additional supply of the appreciated metal by melting, being confined to one or a few countries, cannot affect the supply of the metals in the world market as much as in the case of international bimetallism where the area over which the operation of such minting and melting goes on affecting the supply of the metals is practically co-extensive with the area, the whole world, in which the relative value of the metals as bullion is determined.

Advocates of bimetallism as a monetary reform suitable as a remedy for the monetary troubles of the present times point out several advantages which, it is claimed, will accrue if the system is internationally adopted by most or all countries of the world. During the period of depression all countries were anxious to discover fresh markets, or more fully exploit existing markets for the

products of their industries. The case of China was prominently brought forward as a country with vast numbers and with only its coastal areas sufficiently developed as a market for foreign commodities. It was said that one main obstacle in the way of fuller exploitation of the Chinese market was the fact that the currency in that country was silver and that the lack of stability of silver value in terms of gold made it difficult for China to purchase on a wider scale the commodities which were produced in large quantities in countries whose currencies were linked with gold. Therefore, if a system of bimetallism could be adopted all over the world by virtue of which silver would be restored in value or as a result of which the silver currency of China would be stabilised in terms of gold, the Chinese market would prove to be of immense value to the other countries of the world. Unfortunately, a lot of sentiment was mixed up with the appeal to help China in her political distress, which the Chinese Government, with its usual promptitude in such matters, did not fail to exploit for international political purposes. It is obvious that merely steadying the value of silver will not go far. Other economic developments must come about, especially safe and rapid means of communication with the interior, before China can be a good market for the products of Eur-American industries. But an immediate rise in the value of silver in terms of gold would appreciate the Chinese currency and enable the people, even of the coastal areas, to purchase more of foreign commodities.

Another advantage likely to accrue from bimetallism is that fluctuations in the value of currencies linked with gold will be less than at present. The total stock of gold in the world to-day may not be too short for the monetary needs of all the countries. But its annual output is certainly failing to keep pace with its demand for monetary purposes. Also the stock of existing gold is so distributed at present that many countries have felt an acute shortage. Therefore, falling gold prices create an additional problem in currency fixation. If, therefore, silver is introduced jointly with gold as the currencies of the world this shortage of gold cannot have the same disturbing effect upon prices as it has hitherto had. The advocates of easy credit have also supported the introduction of bimetallism on the ground that it would be easier to obtain and maintain the requisite amount of metallic reserves if both gold and silver were used for the purpose. Every proposal to introduce

bimetallism has always had the enthusiastic support of the producers of silver, especially in the U.S.A. But their object is selfish and not monetary reform.

Some advocates support the introduction of bimetallism but do not want any fixed ratio of value between gold and silver for monetary purposes or as reserves. But this will only introduce fluctuations which will make things uncertain. For a time the loss may probably be borne by the central banks but it is doubtful whether this kind of loss can be accepted as a permanent policy by any bank. On the other hand, with a fixed ratio the danger is that the market ratio may vary. The latter is a much lesser evil of the two since the original objection to bimetallism on this ground does not apply. This objection was that for a time—though a short time—there would be a process of minting one metal into currency and melting the other metal into bullion. This will create a brief period of flux This objection does not hold now because the proposal for adopting bimetallism does not want actual metallic currency but it wants to have only paper currency which will be covered by gold and silver at a fixed ratio. Therefore, the adjustment is not to take place through the actual currency but through the cash reserves upon which money and credit would be based.

All attempts in the nineteenth century to establish a bimetallic system with gold and silver metals failed. The most famous experiment was that of the Latin Union in the last century. Owing to the discovery of silver mines in America the value of silver had kept on falling since the middle of the century. Thus all foreign obligations to be met in gold by a silver-using country increased in proportion to the fall in the value of silver. At that time Britain was the only country in the world using gold in its currency but its foreign trade was so large that its influence was predominant in all international affairs. To meet the crisis France and most other countries of western Europe combined into what is called the Latin Union in order to stabilise by law the relative value of gold and silver currencies. The experiment failed, as it was bound to fail, because what was introduced was virtually national, and not international, bimetallism. As a metal silver depreciated in terms of gold because of increased output. But the relative value of gold and silver coins was fixed by law. Thus silver became appreciated as coin and depreciated as metal. In this way

it became profitable to melt gold coins and to mint silver into currency. As the relative value of gold and silver as bullion was determined by world conditions over which the Latin Union had no exclusive control, the process of melting gold coins and minting silver coins went on till, owing to continued depreciation of silver as a result of increased output, gold disappeared altogether from circulation and silver alone remained in the currency. The Latin Union thus failed in its purpose and finally gave up bimetallism and adopted the gold currency. Even with gold currency the preference for silver persisted till 1914 in many countries of the Latin Union. In France the cash reserves against bank-notes consisted of gold and silver and the central bank had the option to pay in either metal for purposes of export. In Spain the same system existed at least up to 1938 after which its history is somewhat obscure. When the Latin Union adopted the gold currency India found gold currency too costly and adopted in 1893 a system which developed early in this century into a novel system called the gold exchange standard which has given many new ideas to the reformers of currencies of the world. This will be discussed in the next scheme to be considered under controlled currency.

In the United States of America the system of bimetallism has been advocated since the last quarter of the nineteenth century. The reasons were partly the same as those which led the Latin Union to adopt bimetallism. The U.S.A. was at that time a country with a silver currency and all the monetary troubles following on silver depreciation arose there as well. In addition to this, the U.S.A. is a silver-producing country. Although the actual output of silver is rather small yet for some reasons not quite clear the advocates of bimetallism have been more numerous in the U.S.A. and have persisted up to the present times. This has been in spite of the fact that the U.S.A. adopted the gold currency about sixty years ago. With the last financial depression which began in the U.S.A. in 1929 the advocates of bimetallism again became strong and were able to persuade President Roosevelt to declare in 1933 that the policy of the Administration was to restore bimetallism in the U.S.A. as a permanent measure of monetary reform. The suporters of the policy were not all bimetallists. Many advocates of the expansion of credit and many others who expected a revival of American trade in China and other countries of the Far East supported bimetallism

in the hope that their separate purposes will be advanced by this means. In 1934 a law was passed according to which the cash reserves of the country were to be of silver to the extent of 25 per cent of their total value. In order to achieve this within a short time the U.S.A. purchased huge quantities of silver in the world market and compelled all holders of the stock of silver within the country to sell it to Government. At the same time the price of silver was fixed at a high value which was not justified by the economic circumstances in the silver market. This naturally led to grossly speculative transactions in silver, which ended in a slump that had to be accepted by Government. The speculative rise in silver was so great that China which, as a whole, had never known any other money but silver, had to demonetise silver. Thus one group of supporters of bimetallism, that is, those who hoped for an immediate and direct increase in the trade between the U.S.A. and China, were severely disappointed. It should be noted that this artificially high price of silver and the consequent speculative boom followed by the slump form no part of the system of bimetallism and should not be taken as arguments against it. These were wholly extraneous methods unnecessary and as the circumstances proved, harmful to the introduction of bimetallism as a measure of currency reform. The U.S.A. is still persisting in its continuance of bimetallism and the experiment should prove a useful lesson to others who may think of introducing bimetallism as several countries in South America are thinking and as China later on may also think.

CHAPTER XII

Managed Currency—National

The object of introducing the system of managed currency is to have effective control by Government. The purpose of such control is to initate and retain a proper balance in the economic life of the country. There are many disturbing factors in economic life, which arise as a result of purely economic causes. These naturally affect the trade and production in the country and for the time being, upset the equilibrium of economic conditions. Ultimately a new balance will be reached but in the meantime there will be disturbances. Also the ultimate equilibrium may not be conducive to the economic prosperity of the country. Therefore, in order to maintain a particular line of economic development in a country the system of managed currency has been suggested by many economists. Some advocates want such management for a particular purpose only and understand by management only action to serve such purpose. For example, some want a continuous expansion of credit. But the meaning of management cannot be confined to such narrow limits only. Whether expansion or contraction, if the situation is brought about by Government control, it must be considered as part of the operations of the managed currency. Sometimes managed currency is associated with suspension of the gold standard. This is wrong as will be seen from the gold exchange standard which obtained in India since the beginning of the present century. In that system gold was retained in the monetary system; in fact, gold was for a time even in circulation. It formed the effective reserve through which the currency used to be regulated. Because gold is thus retained in the monetary reserve it does not necessarily follow that the volume of currency and credit must be left to automatic adjustment as in the old system of gold standard. Nor need the interest rate be allowed to lie purely at the mercy of the fluctuating conditions of the open market. If that were done credit conditions and therefore the interest rate will be completely under the influence of the amount

of gold which is in the country or will be determined by the price level in the world. But this sway of world conditions in prices or flow of gold should not, according to the system of managed currency, be allowed adversely to affect the internal conditions of the country.

Thus the system of managed currency means the deliberate adoption of a definite policy by the country introducing the system. It means a systematic control over the volume of currency and credit in order to determine their total amount which will be made available at any time. Of course, this quantity will be regulated according to the needs of the country as also the particular purpose for the attainment of which the policy will have been initiated. Such control over the volume of currency and credit will also mean control over the rate of interest which will prevail in the market. Managed currency may, therefore, be said to have a definite purpose and a fixed method. The latter is the control of currency and credit and the consequent control of the rate for money. The general purpose is to bring about the economic prosperity of the country. But in interpreting this purpose there is a divergence of opinion among the supporters of the system, some emphasising one aspect and others other aspects. Generally speaking, such emphasis regarding the purpose of the managed currency may be seen in a few broad divisions of opinion emphasising different aspects of the case. There are those who think that the most important function of such a system is to assure that the external stability of the currency is maintained. In other words, the exchange rate must be kept stable. This is what the Indian system has tried to do. We shall have occasion to discuss this system in greater detail. Secondly, there is a body of opinion according to which the main purpose of the managed currency should be so to ordain the economic development within the country that there would be no unemployment and all able-bodied adults will find employment. It is also claimed that the currency policy is capable of being handled in such a manner as to maintain a continuous increase in the production of wealth and that this will lead to a steady rise in the standard of living as also to progress in such works as housing, roads, etc., which will bring greater amenities of life to all members of the community.

The third purpose is the one which has drawn the largest number into supporting the system of managed currency. It is

stability of prices. After the last European war there were such tragic fluctuations in prices for a considerable time and these wrought such havoc among many classes of people that in the opinion of a large number of people the most important desideratum for economic prosperity is stability of prices within the country. They argue that if prices fluctuate frequently there cannot be any steady progress in the trade and production. The ordinary producers and sellers will be affected by such fluctuations as also the consumers in general. An element of speculation enters into ordinary economic transactions and such speculation has an unhealthy effect upon all those who are not used to or who do not want to get mixed up with speculative transactions. Such fluctuations also upset all normal calculations of business men in the matter of prices and cost of production and thus nobody can form long-term plans for trade and industry, even for personal consumption, since the uncertainty of price fluctuations is likely to make such calculations ineffective. If the stability of internal prices is maintained as the prime object of the managed currency, then only is it possible to have in actual life that long-term adjustment of cost of production to prices, which can make possible an efficient system of production to be carried on. Of course, it is admitted that for lasting and permanent maladjustment, especially among the various individual industries within the country, some variation in the prices will be necessary. But the usual fluctuations, which are mostly for a short period and which are normally followed by a reverse movement after the automatic adjustment contemplated in the old system of gold standard has taken place, should not be allowed to bring about a continuous series of disturbances in the economic organisation of the country. Also price fluctuations, which are sudden or which are the result of conditions in other countries with which the normal trade relation is remote should not be allowed to have any repercussion upon the home industries. Thus the supporters of stability of prices conclude that price fluctuation is a great evil to the economic life of the country since it constantly disturbs the equilibrium which the economic life seeks in its normal course and that therefore the main purpose of the managed currency should be the maintenance of a stable price level.

There is another body of people who oppose stability of prices while supporting the introduction of the system of managed currency. Their object is also the same as that of the supporters of stability,

viz. to bring about an all-round economic prosperity. They argue that stable prices are no encouragement to the growth of industries. At best these have a negative effect by removing the evil effects of fluctuation in prices. In this respect they do not differ from the supporters of stable prices and they admit that there would accrue benefits from the policy of stable prices at times when there is great uncertainty owing to price fluctuations. But the removal of the latter only brings back the conditions of the older days and does not do anything directly to encourage the development of the country. They therefore argue in favour of a gradual rise in prices. The means to be employed in this behalf will be a steady expansion of currency and credit and a fall in the rate of interest. The corresponding rise in prices will act as an effective and sure stimulant to industries and the fall in interest will be a help for such industrial progress. It is not quite clear how there can be an expansion of credit through the system of managed currency for an unlimited period. The policy cannot be pursued indefinitely without a break-down of the system itself. Nor is it clear how the system can prevent occasional contraction of currency in times of an adverse balance of trade, say a seasonal failure of crops in the country or a boom in the rival industries in another country which sells in the same neutral market.

There is again another class of people supporting the system of managed currency who also want to bring about economic prosperity by currency manipulation. They are opposed to stability or rise in prices and advocate the policy of initiating and maintaining a moderate but steady fail in the level of internal prices. They argue that during the present century there has been great technical progress in all kinds of industries and that their extent is almost as great as the progress of technical improvement which took place in the latter part of the eighteenth century and which ushered in what is known as the industrial revolution. The effect of such a wide range of technical progress should be to reduce the cost of production by making it more efficient in terms of units of productive factors. This is the result of mechanisation which has been introduced in almost all departments of the economic life of the country. They rightly ask whether the fall in the cost of production consequent on this technical progress has brought about any corresponding fall in prices. As obviously prices have not fallen to anything

like a corresponding extent they argue that no benefit obtained out of technical progress has been transferred to the actual consumers of commodities through reduced prices. If this is so, there has arisen within the economic machinery a serious maladjustment which has upset even the old distribution of wealth among the members of the community and which is only helping further concentration of wealth in the hands of a few. Thus, instead of ameliorating the conditions of the masses by transferring to them some portion of the benefits of technical progress the social organisation is loading things heavily against them. Therefore, they argue that the system of managed currency should be used deliberately for purposes of more equitable distribution of the national wealth among the people of the country. This can be done by lowering the price level so that the fall in the cost of production as a result of technical improvements will transfer to the consumers at least a portion of the benefits accruing to industries. It is obvious that the supporters of this view have no faith in competition as an effective means to that end. Normally, under the old system, it was presumed—and presumed rightly that if there were a fall in the cost of production for any reason that fall would be reflected in the final prices, for under a system of free competition the eagerness of producers to sell in the open market and in open competition with rival producers would in the long run bring down the selling prices to the normal long-term cost of production. But it is argued that these conditions which prevailed formerly do not obtain now. There is no free competition in the old sense between the home and foreign producers owing to the great obstacles artificially raised in the way of foreign trade. Even within the same country there is little freedom of competition left in any industry owing to Government intervention in the economic life of the country to a much greater extent than could be thought possible in the last century. Also combination and federation of industrial units have very much restricted the scope of such free competition as must be presumed to exist in order to enable selling prices to fall in response to a fall in the cost of production. Further, there is little of free market left outside the country and there is such a scramble for the few really neutral markets that sale in such markets is always uncertain. But as commodities are still produced with the hope of selling in such markets a part of such production is always wasted and its cost only increases the business cost of the rest of the products which therefore have to be sold at a higher price in order to cover the total cost of

production. This kind of speculative production on a larger scale than can be sold should be discouraged. If this is done full advantage of technical progress can be obtained in a fall in the cost of production and selling prices can accordingly be reduced without any loss to the producers. Again, it is argued that market conditions fluctuate so frequently and in such an uncertain manner that there is little time allowed for the normal cost of production to find its level and get adjusted to normal prices. Such disturbances are mostly due to world-wide disturbances and not confined to the country in question. Therefore, if the system of managed currency is introduced the shock of world disturbances will be eliminated or at least considerably reduced. This will allow a proper adjustment between prices and the cost of poduction within the country. As the latter is expected to fall owing to technical progress a steady fall, artificially maintained, in the level of prices will transfer a portion of the benefits to the consumers without in any way inflicting a loss upon the producers.

The above series of arguments does not attempt to meet the argument for psychological depression which always follows when prices are falling. Nor is any attempt made to reconcile the conflict between lower prices through a contraction of the currency and credit and the rise in the rate of interest for money which must follow from such contraction. It may also be noted here that the difference between the supporters of a fall in prices and those of a rise in prices as the main purpose of the managed currency is not so great as it appears on the surface. The object of both is to attain general economic prosperity. The question is one of methods. If there is a fall in prices the consumers get the benefit through lower prices. If there is a rise in prices more purchasing power will be placed in the hands of the people, which can be used—a portion of which is always used—in greater consumption. In either case the standard of living is expected to rise. The question therefore is whether the results of technical progress should reach the consumers through lower prices or through greater purchasing power.

It should be clearly understood that the supporters of the managed currency, whether for stability of prices or for greater employment, whether for a rise or for a fall in prices, always presume economic planning without the existence of which their main object will not be successful. They recognise the fact that

management of the currency is no remedy for any lack of harmony that may exist or that may arise among the various industries of the country. This can be cured and in order to make their purpose effective this must be cured by an effective system of national planning. So far as planning on a nation-wide scale does not exist or to the extent that this is not possible in the existing condition of knowledge or owing to the absence of machinery for the purpose the scheme of managed currency directed to the attainment of the specific objects advocated by their supporters will necessarily remain ineffective.

The exact processes by which management of the currency can be attempted may take various forms and go to various lengths in interfering with the currency. Some were in use even before the war of 1914-18. The minimum interference in this respect may be said to exist since the organisation of banking took shape in the present form. When the system of central banking with the concentration of cash reserves mostly in the central bank came into existence a certain amount of management of the currency started at once. This in fact was taken over by the central bank from its constituent banks which had followed the system. When the gold reserve fell below a certain limit as a result of an adverse balance in foreign trade the bank rate used to be raised in order to discourage borrowing and withdrawal of gold for purposes of export. This would bring about a contraction of the currency and credit and lower internal prices. A fall in the home prices would discourage imports and encourage exports, thus counteracting the adverse balance which had existed. The higher bank rate would draw in foreign gold for purposes of investment in the country and this would help to expand the currency and credit to the former level after the effects of the adverse balance had been fully neutralised. Thus it will be seen that management of the currency in the sense that its amount and that of credit based upon it at a particular time should be regulated has been in existence for a long time. During the last quarter of a century the central bank has gone much further than this mild form of management although the nature of interference has not varied much. The central bank is not satisfied with manipulating the currency with the bank rate alone. It directly operates in the market in order to achieve the object. If there is an adverse balance of foreign trade the necessary contraction of the currrency

and credit may be immediately brought about by the central bank selling gold or securities in the open market. The effect of such a sale is the transfer of money and credit from the market to the central bank. This transfer really means that so much currency with its accompanying credit may be withdrawn from circulation if the central bank so desires. This contraction in the currency and credit will at once turn the tide against the adverse balance by lowering prices within the country, thereby encouraging exports and discouraging imports. On the other hand, when there is a favourable balance of foreign trade gold flows into the country. This will ultimately expand the currency and credit. The gold will flow into the central bank and expand the currency and credit of the country, thereby raising prices. This rise in prices will discourage exports and encourage imports, thus counteracting the effects of the favourable trade balance. The central bank may go further and buy gold and securities in the open market. This will release more money into circulation and serve the same purpose. The difficulty which the central bank has faced, in times of strees, is in the former case of an adverse trade balance. After the last war the stock of gold in most European countries has been comparatively small. Every country feels that if there is a strong and persistent demand for gold for purposes of export as a result of an adverse balance the central bank may not be able to meet such a demand and may have to contract the currency and credit to such an abnormal extent that the repercussion on the trade and production of the country would be disastrous. On the other hand, the effects of the opposite process of an inflow of gold may be also very embarrassing as can be seen in the U.S A. where a huge quantity of its gold has been sterilized, that is, simply put away without any monetary use. For, if the whole amount is used, there will be such an expansion of credit and such a rise in prices that the country will not be able to sell its products to any outside countries.

It will be seen that the immediate purpose of all this management of the currency has been to maintain the gold standard. Formerly the gold standard always meant the existence of a gold currency. This has now ceased in all countries of the world. But the paper currency which is maintained for internal purposes is everywhere linked with gold whenever foreign payments have got to be made. Thus although the gold currency has disappeared yet it cannot be said that the gold standard has done so. Also it should be noted

that the methods of management of the currency, so far examined, have been directed to the one purpose of maintaining the gold value of the paper currency. This may be a legitimate purpose; in fact, in the modern world this must be an important object if international trade connections are to be maintained. For there is no doubt that in spite of the repeated onslaughts on gold it still holds the ground in all economic dealings among the countries of the world. That is why the regulations of central banks in regard to currencies have mainly been concerned with the flow of gold from one country to another. But there are many supporters of the system of managed currency whose purpose is to bring about a greater revolution in the regulation of the currency than what the orthodox currency policy has been forced to do by the exigencies of the situation, *viz.* manipulation of the bank rate and open market operations by the central bank in order to adjust the flow of gold into or out of the country. Those who advocate the policy of cheap money or expanding credit also support the system of managed currency. But their object is to make it serve the purpose for which they advocate the policy of cheap money or expansion of credit. This is not being helped by the existing policy of interference by the central bank. Another body of people want to abolish unemployment and support the system of managed currency in order to enable it to be operated in such a way as to give greater employment within the country. At present none of these people are satisfied with the operations of the central bank and they insist upon action on a wider scale in order to achieve their purposes which they consider to be within the legitimate province of the system of managed currency. Therefore, in their opinion it is not sufficient if the central bank manipulates the bank rate or deals in securities in order to bring about an expansion or contraction in the currency and credit of the country, which is so closely and, in their opinion, so disastrously linked with the movement of gold. In their enthusiasm they go further and even question the necessity of any gold backing for the internal currency. They say that a rigid limitation of the total volume of the currency should be practised in order to avoid any inflation of the type that took place in several countries of Europe in the twenties of the present century. But that limit leaves a very wide margin for manipulating the currency and its superstructure, credit, in such a way that a steady expansion can be maintained for an almost indefinite period. Such an expansion will

confer on the country all the benefits of cheap money and abolition of unemployment, thus bringing in an era of all-round prosperity in the country. Therefore, they want that the currency should be entirely divorced from gold. It need have no value in gold and should consist only of inconvertible paper money.

This scheme of inconvertible paper money is worth our consideration because there has in recent years grown a volume of opinion in support of the scheme. Its main purpose is to introduce a currency which will be managed but for other purposes than linking it with gold. It is argued that the gold standard is bad and should be finally scrapped. It is based upon the production of gold, which is an uncertain factor depending upon the accident of gold-finding over which man has no control. Also the distribution of gold among the countries of the world is now so hopeless that it is impossible to devise any practicable scheme of re-distribution on an equitable basis. A huge quantity of it has been concentrated in the U. S. A. where it is not used for any monetary purpose. In normal course under the older system this gold obtained mostly in payment of commodities purchased by the European countries should have found its way in circulation. This would have enormously expanded the currency and credit of the U. S. A., raised prices there, and would have enabled the European countries to bring it back to them by heavily exporting their products to the U. S. A. This accumulation of gold could proceed for a long time because of the war of 1914-18 during which the European countries could not carry on normal trade with the U. S. A. and had only to import from the latter in exchange for the gold. After the war, owing to the vast accumulation of gold in the U. S. A., it was impossible to put the whole of its gold into circulation without disastrous consequences upon its trade and production. Thus the impossible situation has been created in which, under a gold standard, the European countries must obtain gold for all foreign payments, if not also for maintenance of the internal value of their currencies, and at the same time the U. S. A. is unable, also for economic reasons, to use its gold for monetary purposes and has got to sterilize it. Therefore, it is argued that gold should be altogether given up from the currency. It is also said that the main reason why world disturbances in prices arise and cause corresponding disturbances in internal prices is because the attempt is being made to

keep up the external value of the internal currency in terms of gold. All these evils will disappear if the internal currency is entirely separated from any connection with gold so that gold will have no influence upon the value of the currency. It is suggested that the only way by which this complete separation can be brought about is by making the internal currency consist of inconvertible paper currency, that is, it should not have any value in terms of gold and, therefore, will not be affected by the production or distribution of gold.

This managed currency which will consist of inconvertible paper currency may again be studied from two points of view. There are some who advocate that an attempt should be made to have such a currency for all countries of the world so that there will be one international currency for the whole world. Supporters of such international currency have also separate schemes which include the scheme for international co-operation for exchange clearing. We shall have occasion later on to discuss these schemes. Here we shall confine ourselves to the discussion of the national system of managed currency. It is obvious that if the currency is, in the proposed manner, entirely dissociated from gold and if gold, as it is presumed, still remains the ultimate medium of settling international debts, the country adopting this variety of the managed currency must also sever all economic relations between itself and the rest of the world. For if any connection by way of external trade is retained it must some time or other involve payments to be made abroad or to be received in terms of gold. Any such payments will automatically establish a gold value of the internal currency, which, under the scheme, must be avoided. In the alternative the scheme will have to identify itself with the system of pure barter which has already been considered. This complete severance of all economic relations with the rest of the world will also be necessary in order to preserve unhamphered any internal policy of expansion or employment. For without such severance the expansion or contraction of the currency and credit will have, at least to some extent, to be done in response to the exigencies of foreign trade. If this is done the system will no longer remain the exclusive system of national currency as desired by the policy. Also this is likely to bring about a conflict in two opposing policies. As a result of the situation arising out of foreign

trade there will be need for contraction if there is an adverse balance of trade and this will be in conflict with the policy of cheap money or expansion of credit or cure for unemployment.

It will be readily seen to what difficult position a country will be reduced if it adopts this extreme policy of the national managed currency and isolates itself completely from all economic forces of the world. There has been no example of such a country except Japan and China up to the middle of the last century. The vast improvement in the economic conditions of these two countries during the last half a century shows the economic folly of such complete isolation. In spite of this several countries in Europe have kept this economic isolation steadily in view in reorganising their internal economy under what has been called—it appears, mistakenly called—economic planning. The absurdity of the system was further demonstrated by the fact that most of these countries thought of economic isolation only in terms of imports. The undeclared policy of most of these countries has been to prevent, if possible, all imports and yet go on expanding their industries not merely to produce sufficient commodities for consumption at home but deliberately to produce a large surplus which is expected to be sold in foreign markets. Pushed to its logical extreme this will mean that no country will import commodities from outside but all countries will sell their products abroad. Therefore, this action on the part of some countries should not be taken as a deliberate policy of economic isolation but merely as a desperate measure to stem the tide of imports which strangle their home industries, lead to greater unemployment, and create difficulties in settling their foreign debts. But the natural implication of a deliberate policy of the national managed currency will be to introduce such economic isolation as a permanent feature of the life of the country.

In actual practice monetary management has made little progress beyond the method of varying the bank rate and the post-war method of open market operations by buying or selling gold and securities. Both these methods aim at regulating gold movements with a view to maintaining the gold value of the currency. No action has been taken by any country to dissociate its currency from gold or to isolate itself entirely from the economic life of the rest of the world. Therefore, there is no actual case of a country which has followed the policy underlying the adoption of the system of national managed currency in the sense in which the extreme advocates of the policy use the

expression. At the same time it is also clear that the atmosphere for the adoption of such a policy was most favourable during the depression which started in Europe in 1931, since the sudden collapse of American prices made things very difficult for most other countries and offered the greatest temptation to adopt a policy of isolation. Some such measures were indeed adopted by several countries. But none of these measures were adopted as a permanent policy nor for a long time and the attempt was made not for isolation but only for temporary reduction in the foreign trade in order to withstand the threatened demoralisation of all prices. In Britain for a brief period of a few months in 1931-32 even when there was an outflow of gold this outflow was not allowed to bring about a contraction of the currency. For a still briefer period on an influx of gold it was sterilized and not allowed to expand credit. The operations of the Exchange Equalisation Account should not be considered as part of the policy of currency management in this sense. Indeed they should not even be considered as directly connected with price movements since their main purpose is to maintain stability of the exchange rate. However, these operations of the Account had some monetary effects. These were purely incidental because they were never meant to have any monetary effect but arose out of the particular method adopted in the operations of the Account. In order to prevent a rise in the gold value of the sterling gold was purchased by selling Treasury Bills. Similarly, in order to prevent a fall in the gold value of the sterling gold was sold while buying Treasury Bills. Thus the expansion or contraction of Treasury Bills had its effects upon internal prices by expanding or contracting credit. But such effect on credit was never the intention of the operations. The intention was to control the exchange rate, that is, the value of gold in terms of the sterling.

In France for a time a high degree of management could be seen but its purpose was to conserve gold within the country. The measure only incidently affected credit. For a short time, in spite of the pressure of an adverse balance and a rise in the bank rate a contraction of credit was avoided in order to prevent any discouragement to the reviving trade which was taking place in 1935 |

CHAPTER XIII

The Indian Currency

Some supporters of the system of managed currency have realized the fact that it is impossible to isolate the economic life of the country without disastrous effects upon itself. Therefore, they advocate a compromise between the gold standard and the managed paper currency. It is argued that a limited quantity of gold must be retained in order to support foreign exchange. It should be noted that the amount of gold necessary for such a purpose will not be to the total value of foreign trade of the country. The debt to be liquidated between any two countries will be to the extent of the balance. Thus it is not the total foreign trade nor the exports or the imports which will determine the amount of gold required to maintain the external value of the currency. But it is the balance at any one time—either the excess of exports over imports or that of imports over exports. In this form the scheme differs little from the system which was adopted in India early in the present century and adopted on a wider scale after the last war. The scheme has one great virtue, *viz.* that it takes account of the realities of world conditions. Theoretically it may be correct to say that gold is like any other commodity and should not be allowed to dominate, as it has been dominating for over a century, in all international monetary relations. But the patent fact is that gold has beeen so associated in the minds of men as a stable form, and therefore a good store, of value that in times of panic even individuals within a country with paper currency rush on to hoard gold as the safest form of storing away wealth. When this is so for individuals within a country in which gold is not the currency this is much more so for purposes of international trade in which man has known no other medium than gold. Therefore, in the circumstances it is of no use to advocate the immediate acceptance of a system from which gold will be altogether eliminated. But in view of the unsettling effects due to uncertainty in the production of gold and due to its present

maldistribution among the countries of the world every effort should be made to reduce the use of gold to its minimium. And the minimum use of gold is the aim of the system known as the gold exchange standard.

In view of its great importance and wide acceptance in the post-war period we shall discuss the scheme as it has been developed in India and from which it spread to the rest of the world. In India it was not adopted deliberately as a system but arose out of the breakdown of the contemplated gold standard which never came into existence. It will be a help towards the clear understanding of the problem if it is remembered that the Indian system was developed at a time when gold was actually the currency of almost all the countries of the world and when therefore fixation of the exchange rate—within of course the specie points—was considered absolutely necessary.

The system was first developed in India towards the beginning of the present century and has since been adopted in many other countries. In a modified form, what is called the gold bullion standard, it was adopted in many of the European countries.

A short history of the system in India will make it easy to be understood. In 1835 the rupee was made the only full legal tender. The rate of exchange was about 2s. and depended upon the relative value of gold and silver as metals. Up to 1893 it was a free coin. But owing to the discovery of silver mines in the middle of the last century, especially in North and South America, there began a continued depreciation of silver during the second half of the nineteenth century. As a result the rupee could not be considered as equivalent to 2s. Silver depreciation brought about a drastic fall in the rate of exchange as quoted in terms of the sterling. This introduced great uncertainty in all foreign transactions since the rupee equivalent of payments to be made or received kept on changing. This also introduced an undesirable element of speculation in all normal transactions of trade and commerce. A general desire for stabilising the external value of the rupee was manifest. The proposals for international bimetallism failed at the monetary conferences of 1878, 1881, and 1892. In the meantime, one after another, the more important countries of the world—Germany, Japan,

France, and the United States—demonetised silver and adopted gold. This increased the demand for gold, reduced that for silver, and increased the supply of the latter by demonetisation. Thus silver depreciated further. India was a debtor country, having had to meet large obligations in the United Kingdom. Every fall in the value of the rupee meant a rise, in terms of the rupee, of the sterling obligations to be met abroad. By 1893 the rupee had fallen to less than 1s.

In order to prevent this difficulty India had two alternatives, *viz.* to adopt gold in the currency or otherwise to stabilise the rate of exchange. The former was found to be too costly and also unsuitable for the value of the internal exchange transactions. Thus the problem was how to keep the rupee as the internal currency and at the same time to have a steady exchange rate with gold-using countries, that is, the countries with which the major portion of India's foreign trade was carried on. To secure this end it was necessary to bring about a divorce between the money value and commodity value of silver, so that the continued fall in the latter may not affect the fomer. This could be done by making the rupee a token coin. In order to achieve this end either of two methods might have been adopted. The face value of the rupee might be kept as it then was, that is, less than 1s., and its metallic content reduced; or the metallic content might be kept as it was and its face value raised. As the rupee was circulating for a long time as a coin of a certain definite weight and fineness and was being used also for other than currency purposes, *e. g.* by goldsmiths, etc. it was rightly considered prudent to resort to the second alternative. Thus the metallic content of the rupee was left intact and its face value was raised to 1s. 4d. Making the rupee a token coin necessarily meant stopping its free coinage. This made the coin absolutely safe so long as the price of silver was falling or remained steady. But it is apparent that if there were a rise in the price of silver the rupee coin would be threatened because the price of its metallic content might rise up to and exceed its face value, when it would be profitable to melt it.

Government did not try to maintain the new rate and so it became more or less ineffective, the actual rate reaching 1s. 4d. only in 1898. Next year, with the ultimate object of introducing the gold currency, the sovereign and half-sovereign coins of Britain were made full legal tender along with the rupee at the fixed rate of 1s. 4d. to the rupee At the same time some machinery had to be set up to

maintain the rate of exchange between the rupee and the sterling which was then equivalent to gold.

It is well-known that the rate of exchange depends upon various factors in the foreign transactions of a country, which may entitle it to receive payment from abroad (favourable balance) or oblige it to make payments to other countries (adverse balance). Thus the rate depends upon the supply and demand of foreign bills, which ultimately depend upon the balance of indebtedness. Therefore, merely fixing by law the rate of exchange between the rupee and the pound sterling by Government would not establish it as the market rate. In order to do so either or both of two systems might have been introduced. Government might undertake to convert sovereigns into rupees and rupees into sovereigns. Government undertook the former but not the latter. The danger thus was that for purposes of foreign trade gold for purposes of export might not be available in India even when the rate had moved to the specie point. A similar difficulty in regard to gold import was less likely, as gold could be had from the currency of other countries and converted in India into rupees. It should be noted that the occasions for exporting gold from India are few, as India normally has a favourable balance of trade. But a failure of the harvest may suddenly reduce exports and, therefore, the supply of foreign bills in India. This would immediately lower the rate of exchange.

The machinery which Government set up for maintaining the rate of exchange was the system of selling Council Bills and Reverse Council Bills. Council Bills are rupee drafts drawn by the Secretary of State for India in London upon the Government of India and sold in London. Reverse Councils are sterling drafts drawn by the latter in India upon the former and sold in India. When there is an excess of exports over imports the supply of sterling bills becomes greater than their demand. This raises the rate beyond 1s. 4d. The Secretary of State offers to sell rupee drafts at 1s. 4d. plus the cost of transporting gold from Britain to India. Thus the Indian exporter will refuse to sell his sterling drafts at any price beyond 1s. 4d. plus the cost of transporting specie, inasmuch as he can, through Council Bills, get the remittance from Britain. Thus the sale of Council Bills effectively restricts the upward movement of the rate to 1s. 4d. plus the cost of transporting specie. On the other hand, when there is an excess of imports over exports, the demand for sterling bills becomes

greater than their supply. Therefore, the price of the bills rises, *i. e.* R 1 can now buy less of sterling. This lowers the rate below 1s. 4d. The Government of India offers to sell sterling drafts at 1s. 4d. minus the cost of transporting specie. Thus the Indian importer will refuse to buy his sterling drafts at any price below 1s. 4d. minus the cost of transporting specie and make his remittance with Reverse Council Bills. In this way the sale of these bills effectively prevents the downward movement of the rate from falling below 1s. 4d. minus the cost of transporting specie. This is the machinery which Government set up in 1899.

But for Government to be able to draw such bills, particularly upon the Secretary of State who has no independent source of income, it is essential to have a reserve of cash to meet such bills. The profits of rupee coinage—now a token coin—were earmarked for this reserve which is called the Gold Standard Reserve.

After the war of 1914-18 central banks in most countries started with open market operations. In India, which at that time did not have a central bank and where all such operations were performed by the Government of India, the contraction and expansion of currency and credit were also done by Government undertaking such operations in the open market. Thus when owing to a favourable balance of foreign trade there arises the need for expansion Government does not rely merely on the method of selling Council Bills. It buys gold in the open market or buys foreign bills in India. The effect of such operations is the same as the sale of Council Bills since by means of such Government purchase more money is put into circulation and this brings about an expansion of the currency and credit. On the other hand, when owing to an adverse balance of foreign trade there arises the need for contraction Government, in addition to selling Reverse Council Bills, also sells gold and, in rarer cases, raises a loan thereby withdrawing money from circulation. This brings about a contraction of the currency and credit.

In 1900-01 Government introduced a large amount of gold sovereigns and half-sovereigns into circulation as a step towards having a gold currency in India. But by the end of 1901 it was found that all the gold coins had disappeared from circulation either by being returned to Government or by being transported beyond the borders. From this Government concluded that India did not want

the circulation of actual gold coins. Its critics, however, point out that Government made the mistake of trying to put gold into circulation at a time when India had just passed through an acute famine (1899-1900) which affected practically the whole of Northern India, and which, therefore, reduced the value and extent of exchange transactions in general. Hitherto India was having a prospective gold currency. From now India definitely gave up the idea of having gold in circulation and thus adopted the gold exchange standard. However, the Currency Commission of 1912 approved of the system although it suggested gold coinage in India if the people wanted it. Before the recommendations of the Commission could be given effect to the war of 1914-18 had broken out.

As the war progressed the sterling price of silver went on rising. In 1914 it was about 26d. per ounce. When the price is 43d. the rupee loses its token character at 1s. 4d. Thus if the price goes above 43d. the rupee coin can be profitably melted. Also so long the sterling was the same as gold but now it became an inconvertible paper depreciated in terms of gold. By January 1917 the sterling price of silver had gone beyond 43d. and the rupee coins in circulation—about R 300 crores– had to be protected by raising the rate to 1s. 4½d. In 1920 the price went up to about 90d. and the rate to 2s. 10d. The sterling price of silver was affected by two factors, *viz.* (1) The depreciation of sterling. At one time it was 3.23 dollars, the normal pre-war par being 4.86 dollars. Every fall in the sterling meant a rise in the sterling price of silver even when its gold price remained the same. (2) But the gold price of silver did not remain the same. The demand for silver increased because of the depletion of gold from the currencies of the European countries which tried to make up for it by using more silver coins. The supply diminished because of the signs of exhaustion in the Canadian mines and because of the disorganisation of silver production in Mexico and Bolivia as a result of the political turmoils. Further, the supply of gold in the United States increased because of gold having been exported there from Europe to pay for the war materials which America had sold to the belligerent powers. Thus gold prices rose in America, and as America is the most important market for silver, the price of silver rose as a result of this accumulation of gold.

In order to maintain the rate which was fixed in 1920 at 2s. gold Government sold Reverse Council Bills at 2s. plus the extent

of sterling depreciation in terms of gold. The Secretary of State found it difficult to meet these bills, as his fluid assets in the gold standard reserve had been very much reduced. As soon as the sterling price of silver fell below 50d. and the threat of melting the rupee coins removed, Government declared itself unable to maintain the rate of 2s. gold and stopped all exchange transactions to keep up the official rate. Since then up to 1927 the rate was drifting about and the gold exchange standard must be said to have broken down. Since 1924, however, Government was trying to keep a fixed rate near about 1s. 6d. by selling Council Bills whenever the rate tended to go above the rate, and selling gold or Reverse Council Bills whenever the rate tended to fall below 1s. 6d. On the report of the Currency Commission of 1925 further action was taken. The important change which it suggested was to have the gold bullion standard in the place of the gold exchange standard. This makes little difference in the principle of the system. There was, however, a great controversy over the rate as to whether it should be 1s. 6d., the rate maintained by the Government since 1924, or 1s. 4d., the rate which obtained from 1899 to 1916. In 1927 the exchange rate was fixed at 1s. 6d. in terms of gold bullion. But when the sterling went off gold in 1931 the rupee was linked to the sterling and ceased to be linked with gold. Since then India may be said to be a definite part of the sterling *bloc*. The rate of 1s. 6d. was really fixed by Government intervention through its operations between 1924 and 1926 and it was adopted, as probably it had to be adopted, in 1926 by the Royal Commission on Indian Currency and Exchange. As the present writer pointed out in his oral evidence before the Commission, the fixation of the rate was premature inasmuch as the period was unsuitable for the purpose when all the countries of the world were passing through a prolonged period of uncertainty, and monetary policies were being revised and remodelled on new and unorthodox lines.

From the point of view of this book we have little to do with the exact rate to be fixed. We should rather study the effects of a rise or fall in the rate upon the trade and production of the country. From this point of view the effect may be divided into temporary and permanent. Temporary effects are those which affect trade and production before the internal prices adjust themselves to a change in the rate of exchange. Permanent effects are those

which operate only after there has been this adjustment. In India the rate of foreign exchange is quoted in terms of sterling, *i.e.* the foreign currency. Thus if there is a rise in the rate it means that the home currency has appreciated. This has adverse effects upon the exporter, for he finds that he has to surrender more of the foreign currency of the country in terms of which he has sold his goods than he used to do at the old rate. Thus the amount of rupees for the same price at the foreign currency becomes less. Getting less than before he can offer less to those from whom he buys. Therefore, the demand price of the commodities, which is offered to its producers, falls. Thus a rise in the rate first affects the export trade and then necessarily the production of the goods which are subject to the export trade of the country. On the other hand, the rise in the rate helps the importer. He finds that in order to pay for the same price at the foreign currency he has to give less in rupees. This leads to an increase in imports.

These are the temporary effects. If the process continues sufficiently long there are interactions upon exports and imports and, through them by a sympathetic operation on prices, upon most other commodities. If the rate goes up the increase in imports reduces the prices of all imported goods, as also of those which may be used as substitutes for them. Thus a fall in the price of fine cotton piecegoods affects that of coarse ones, a fall in the price of imported sugar brings down that of home made sugar and gur. Further, this fall in the prices of so many articles will lead to a sympathetic fall in the prices of other articles, which are not directly subject of foreign trade. Such a widespread fall in prices will reduce the cost of producing the exported articles. Every fall here will neutralise the effect of a rise in the rate upon their export. On the other hand, a fall in the prices of the imported articles will neutralise those of exports, leaving the two in the same position as before the rise in the rate of exchange. The effects of a fall in the rate will be exactly opposite of the above.

Different interests will be affected differently but ultimately the effects must be as stated above Thus in the long run, that is, when sufficient time has been allowed for the internal prices to adjust themselves to the variation in the rate of exchange, the latter has little effect upon the trade and production of the country. Thus the disturbing effect is due not so much to the rise or fall in the rate of

exchange as to the rising or falling rate, that is, to fluctuations in the rate of exchange.

It is evident that the gold exchange standard depends for its maintenance upon Government and is, therefore, a managed system. From this the conclusion is too hastily drawn that it is therefore not automatic in its operation. It is no doubt managed by Government but it may nevertheless be automatic. The essential feature of an automatic currency is that its amount should vary according to the needs of the country. If, for example, there is an adverse balance of trade it shows that the country is a good market to sell in and a bad one to buy from. The reverse process is at once started by the efflux of bullion or specie to meet the adverse balance when the reduction in the home currency increases its value and lowers prices, thus making the country a better market for buying and a worse one for selling. If this be considered as the fundamental feature of an automatic as opposed to a managed currency, then the gold exchange standard may be automatic even if it be managed by Government. Let us suppose that India and Britain have gold currency and that imports to India from Britain are greater than exports. Now gold will flow from India to Britain, swell its currency, and push up British prices, while the contrary will be the case in India. The remedy will thus be found by cheapening Indian products in Britain and making British products dearer in Indian currency. Therefore, Indian exports to Britain will increase and British exports to India will diminish, and the balance of trade will be restored.

Now let us see what will be the case when India has the gold exchange standard. To make payments to the British creditors Indian debtors will try to buy bills on London. But as the amount of these represents the amount of British debt to India, it will be less than the Indian debt to Britain because there is, as has been supposed, an adverse balance against India. So, the sterling will rise in terms of the rupee, and as gold is not circulating in India the fall in the rate of exchange will tend to be indefinite, limited only by the facility of buying gold as a commodity in India. But here Government will intervene and sell Reverse Council Bills at the official rate minus the cost of transporting specie. This will at once check the fall in exchange by neutralising the excess demand over the supply of sterling bills in India. By this sale Government will realise in rupees the amount of the sterling debt. This must be

rigidly kept out of circulation as a part of the home reserve for maintaining the rate. Therefore, the amount of Indian currency being reduced will rise in value and bring about a fall in Indian prices. This is exactly the process which we want to have in operation in the case of an excess of Indian imports over exports and this is exactly what the gold currency accomplished. It is in this way alone that the home currency responds to the stimulus of trade and this is what we mean to have when we say that the currency should be automatic. Thus it will be seen that a managed and an automatic currency are not two mutually exclusive conceptions but that the two principles can be combined in the gold exchange standard.

The point to be noted is that the Indian currency, locked up by sale of Reverse Council Bills, must never be liberated except to mature Council Bills sold by the Secretary of State to maintain the rate of exchange at par. Unfortunately this has not happened in India. The currency increases when Council Bills are presented to the Government of India, but when Reverse Council Bills are sold the proceeds are not locked up but utilised by Government and thus come again into circulation. In this way inflation of the currency has gone on for years. Another defect has been the investment of the gold standard reserve by the Secretary of State in spite of the vigorous protests of the Government of India. This has increased the reserve but has locked more than £50 millions in securities which have now very much depreciated. But none of these defects are inherent in the gold exchange standard and none of these can be taken as defects of the system itself.

We shall have occasion to revert to a fuller discussion of the gold exchange standard in relation to its international possibilities. Here we may note that no scheme has been suggested in which the maintenance of the currency in terms of gold can be better combined with any other monetary policy, which has been proposed as practicable for a country to adopt. The policy of cheap money or expansion of credit has been combined in the working of the gold exchange standard in India although this was never admitted as one of the objectives of the Indian currency policy. We shall further see how the system can also be used as a basis for a system of international currency.

CHAPTER XIV

(*a*) **Extension of the Clearing System**

There are a few schemes of monetary reform, which are based on the co-operation of several Governments. Most of the schemes which we have already discussed are also applicable for adoption by all countries simultaneously although such joint action on their part is not essential for the successful working of the schemes. There are a few other schemes which presume such action. Such joint action is expected to make monetary reform more effective. Changes in money values lead to changes in prices. These will affect world prices and through them, the monetary values of other countries. Thus the monetary policy of one country affects that of others. Also high finance is international both in its scope and in its repercussions. It is obvious that in such matters if there can be an agreement among the countries of the world for the adoption of a uniform policy of monetary reform or even of monetary control, the effect is likely to be more steady than when individual effort is made by different countries for the same purpose. This idea of joint action by Governments on the basis of a common policy for monetary reform is not widespread nor popular. The reason is not far to seek. In the past monetary history no attempt has been made to evolve such a common policy except the international monetary conferences of the last quarter of the nineteenth century. This attempt was far from reassuring nor was it expected to pave the way for future co-operation. Also there is a great prejudice against accepting the influence of any outsider upon the monetary policy of a country. Any co-operation must mean joint action and therefore a decision in which other nationals also have a determining voice. The prejudice has been to consider the monetary policy of a country as one essentially its own. Probably this prejudice has grown out of the conscious and obvious hostility to any such scheme from the prevalence of the exclusive idea of political sovereignty. Such idea of sovereignty as has circumscribed the scope of work of the League

of Nations has persisted in several other spheres of national activity including monetary policy. But man in difficulties is apt to look for help elsewhere as well. That may be the reason why schemes of monetary reform based upon the principle of joint action by several Governments have in the past grown at times of great financial or economic trouble. After 1923 when there was a feeling among some people that the system of national currency had failed, several suggestions for monetary reform based upon joint action were made by many writers. After the financial crisis had begun in 1931 a few other schemes were suggested. Most of these were the suggestions of economic theorists or the imaginative writings of enthusiasts. But a few of such schemes deserve consideration.

The most important scheme of this nature is what may be called an extension of the system of clearing houses. Close and continuous co-operation of all the big countries of the world is contemplated in the scheme. The machinery of the clearing house has been of great help in consolidating the organisation of credit within a country. It will be convenient if we recapitulate the main features of the system of clearing house as it has been developed for purposes of operation within a country. The principle of the system is that claims to receive payment are set off against counter-claims to make payment. Thus if the former be of R 50,000 and the latter of R 48,000, money is not used to the extent of R 98,000 but only to that of R 2,000. The stages of development of the clearing house may broadly be divided into three:

1. In the least developed system each bank presents to the others the list of payments to be received from the latter, and after a specified time, say, a fortnight, settlement is made by paying only the difference between the claims and counter-claims subsisting between any two banks. But this involves each bank meeting all the others separately. To avoid this expense, labour, and trouble the second stage was developed.

2. In this all the banks meet at a common place, the clearing house, where each bank presents to all the others its claims to receive money, that is, the cheques which it holds on others, and the others also present their claims upon this bank. Thus the whole work of presentation of claims and counter-claims by all the banks is done in one

room and at one time. This saves a good deal of expense and labour. But even now the final balance between any two banks is settled by actual payment of cash.

3. In the final stage cash is altogether eliminated. Each bank makes a list of its claims on all other banks and obtains the list of claims on it by other banks. This gives a list showing the net claim by or against it in regard to each of the other banks. Now a final list is made showing the net claim by it on other banks, as also that on it by the others. A balance is struck between these two items, thus showing the total net claim by or against it in regard to all the other banks. It is apparent that the net amount to be received by some banks must be equal to the net amount to be paid by the rest of the banks. All the banks keep accounts with the central bank in which there is a separate account in the name of the clearing house itself. All those banks which have to make payment pay by cheques on the central bank to the clearing house, and the clearing house pays those banks which have to receive payment hy cheques on the central bank. Thus the final adjustment is made only by entries in the books of the central bank In this way payment of huge sums of money is made without the use of any cash at all. Thus from the first drawing of a cheque to its final payment cash is never used.

It is evident that the advantages obtained from the system of clearing house depend upon the economy in the use of cash. This depends upon the following factors :

1. The completeness of the chain of adjustment. If there is a break anywhere cash will have to be used at that point.
2. The magnitude of the amount thus settled. The greater the amount the greater will be the economy in the use of cash.
3. The number of cheques presented. The greater their number the greater is the amount of exchange transactions, that is, the trade and production of the country, that are benefitted by the system.
4. The number of the parties making and receiving presentations through the clearing house. If all persons make

payment by cheques and if all banks are members of the clearing house, the use of cash is very much reduced.

5. The difficulties of separate presentation which would be necessary in the absence of the clearing house. If these difficulties be very great the advantages derived from the system increase to the same extent.

From the foregoing description of the operation of the system of clearing houses within a country it is evident that one important result is the elimination of the use of a huge amount of cash in settling debts among the banks within one country. Economy in the use of cash may be said to be the main purpose of the system. It should also be noted that this purpose is also served by any bank having branches all over the country. In settling the debts between two branches of the same bank situated at two different places within the same country no cash is used but the settlement is made by transfers in the books of the bank among its various branches. This amount of clearing does not appear in the list of formal clearing because it is the internal affair of the bank between its branches and therefore is not carried to the clearing house. Therefore, the amount of formal clearing seen in a country's report on the clearing house is not necessarily a correct indication of the actual economy in the use of cash, which has in practice been effected. Britain has a small number of large banks, each with a number cf branches all over the country. Therefore, a great deal of Britain's operation of clearing is done through the system of branch banking and the amount of formal clearing among the different banks is comparatively small. In the U.S.A., on the other hand, the system of branch banking is not so extensive. There we find a large number of banks, each with only a few branches. Therefore, the amount of formal clearing in the U.S.A. is very much larger than in Britain but this is no correct indication of the economy in the use of cash which is effected in Britain and the U.S.A. Again, there are several banks, especially in the British Empire, which have many branches in different countries within the Empire and some even outside it. Some of these countries have separate currencies of their own. In such cases also the internal clearing is large and economy in the use of cash, especially in the transfer of cash from one country to another, is of fairly large amounts. An additional feature of such clearing is that it is not, as in the case of branch banking within a country, a question of settling debts all of which are in terms

of the same currency but of settling debts in terms of two different currencies between two separate countries which have branches of the same bank. Here is a case in which international exchange clearing in its true sense is performed by the bank through its system of branch banking. The scheme which we are discussing now contemplates an extension all over the world of this kind of exchange clearing but not through the system of branch banking but through the establishment of a common organisation which will take the same place for the countries of the world as the existing clearing house does for the banks within the same country.

The scheme envisages the establishment of such an organisation to be set up in a neutral country. Probably the bank for International Settlement in Switzerland will do for the purpose. As debts which are to be settled among the countries of the world and for which gold is required now in large quantities are to be treated like internal debts for purposes of international clearing it is obvious that the usefulness of the international system of clearing, that is, the economy in the use of cash which in this case is always gold, will depend upon the completeness of the chain of debts among the countries of the world, which can be settled by this means. Therefore, the scheme suggests that all individual settlement of debts between private parties, firms, and banks resident in different countries must cease and all must be compelled to operate through the system of international clearing. This means that the existing foreign exchange market for all individual operations must stop. In every country an international clearing house is to be instituted, whose sole purpose will be to arrange the settlement of all debts beween that country and other countries of the world. It will have the same position in international clearing as an ordinary member bank has in internal clearing. All dealings in foreign exchange must pass through this institution. A debtor to a foreign country will pay in this institution in terms of the home currency. This also need not involve the use of cash but can be arranged through the organisation for internal clearing Even if it is paid in cash it will not be gold but the currency of the country in which the debtor resides; that is, the payment, if it is in cash, will be in the paper currency of the country. Through this new institution each country will strike its final credit or debit balance of international debts to be received from or paid to every other country just as within the country itself each member bank does for other banks in the internal

clearing house. The final balances of the member countries also need not be paid in cash, that is, gold. In the case of internal clearing all member banks are required to keep adequate assets at the central bank of the country. The clearing house also has its account there. The final balances are paid by the debtor banks to the clearing house and to the creditor banks by the clearing house, by cheques on the central bank which adjusts the banks' deposits accordingly in its books. Thus no cash is paid at all and the book adjustments in the central bank finish the final operations. In the same way if there is a bank for international settlement at which all the national clearing houses for international debt settlement keep accounts the final balances in the foreign debts also may be adjusted by transfers in the books of this bank for international settlement. It will be seen that such an organisation will complete the scheme for international settlement exactly on the model of internal clearing and will therefore provide for the maximum economy in the use of gold. But even if such a bank for international settlement cannot be immediately organised the system will considerably improve the existing situation. The position then will be like internal clearing without every member bank having its account with the central bank but each debtor bank paying cash to the creditor banks to the extent of the final debt balances. Even this will be a great improvement over the existing condition in which every individual debtor to a foreign country attempts to pay cash, *i. e.* gold, or by bills which ultimately affect the use of gold, and there is no attempt to strike a balance between the credit and debit sides of a country so far as its foreign transactions are concerned.

The advocates of this scheme may be divided into two groups of opinion. The less radical group thinks that this scheme of international clearing should work side by side with the gold standard. Another group thinks that the gold standard should be abolished and this scheme alone should operate for all international purposes. It should be noted that this scheme is not incompatible with the gold standard. As we shall see when we discuss the gold exchange standard it is not impracticable, if sufficient agreement among the countries of the world is forthcoming, to have an international organisation on the basis of the gold exchange standard. The scheme of international clearing is a more modest one and it is not at all difficult for this scheme to operate simultaneously and in conjunction with the gold standard. Of course, when we speak of the gold standard we do not think of actual

gold coins in circulation. That conception of the gold standard may now be said to be a matter of the past. At present and for all future plans the expression gold standard has come to mean a system in which the internal currency of a country is not convertible in gold but its external value for purposes of foreign transactions is maintained in terms of gold and will be so maintained, if necessary, by the transfer of gold, or its equivalent in foreign funds, from one country to another. In this form the gold standard is not only not incompatible with the present scheme for international clearing but the two are in a sense complementary to each other. Even if the clearing system alone is adopted a final gold adjustment may be necessary from time to time at least to put the bank for international settlement in sufficient funds on behalf of a particular country. If no such bank is established and yet the proposed scheme is started, more direct and more frequent transfers of gold may be necessary to settle the final debt balances among the countries of the world.

The more radical supporters of the scheme want it to supersede the gold standard and consider the two systems to be alternatives to each other. According to their scheme the home currency in every country will be a managed currency of inconvertible paper. It this is obtained then by judicious management the currency can be made to serve other monetary purposes than those of settling international debts. Now it can be used to introduce simultaneously other schemes of monetary reform like those of cheap money, expansion of credit, and reducing unemployment. This will be possible because of the complete severance between the home currency and gold. But the supporters of this policy forget that in order to maintain the effectiveness of the system of international clearing it will be necessary to maintain stability between the level of internal prices and the level of world prices. If this is not done within certain limits and if there are wide fluctuations in the foreign exchange rate there may arise difficulties in the operation of the scheme for settling international debts. These debts will be in terms of the currencies of the world. If the relative value of the different currencies of the world vary widely the amount of international debts in terms of the foreign currencies will also vary and while settling the final balances of credits or debits the figures will be swollen against the country if the home currency is substantially depreciated. In fact, the scheme for international settlement

of debts contemplates that there should be fixed rates among the currencies of the world. Of course, there will be no private or individual transactions and all transactions will be through the international clearing house. Also there will be no speculative or arbitrage transactions. The final debt balance between two countries will, so far as possible, be neutralised by opposite balances with a third country and, at the end, through book transfers in the bank for international settlement if such a bank can be set up.

The advantages which will accrue to all the countries of the world by the adoption of this system have been summarised as below by Paul Einzig:

1. It introduces a reasonable spirit in foreign trade relations. As things are, every country aims at exporting as much as possible and importing as little as possible. Under the exchange clearing system the export of goods can be paid for only by import of goods: thus it is not to the interest of any country to try to obtain a huge export surplus by means of dumping or by means of prohibitive import restrictions. Under the exchange clearing system, Governments would be just as keen on increasing their imports as they are on increasing their exports. Governments will have to realise that the exporters and creditors can expect to be paid only if the country concerned is prepared to take a corresponding amount of goods.

2. It substitutes a scientifically regulated system for the existing haphazard method of international transfers. Under exchange clearing the inevitable discrepancies between debit and credit items of a country at a given moment do not disturb the international or internal monetary situation. Instead of causing an unwanted depreciation of the exchange with all its unfavourable consequences, an adverse trend merely causes an accumulation of debit balances on clearing accounts. The mere fact that a country has debit balances does not in itself interfere with the stability of its currency. It does not lead to an outflow of gold which would automatically contract credit. Should the adverse tendency be persistent, it is for the authorities of the country concerned to make up their minds

whether to correct the situation by deflation or by the adjustment of their parities. In no case will their hand be forced by a sweeping speculative exchange movement as under the regime of free exchanges.

3. Exchange clearing safeguards the stability of the currency not only against the effect of an adverse trade balance, but also against speculative attacks and international movements of capital. It provides the most effective and least inconvenient form of exchange restriction. While under any other form of exchange restriction the foreign importer who assists the exporters of the country concerned by leaving part of the profits of exports abroad does not offend the law of his own country, under the exchange clearing system any attempt to circumvent the clearing arrangement by such means would be an offence against the laws of both countries concerned.

4. Exchange cléaring would enable statesmen, economists, bankers, etc. to know exactly every day the balance of payments of thir own country and of foreign countries. Under the existing system those responsible for the monetary policy of the country and those who grant credit to foreign countries or do business with them are completely in the dark about the exact or even the approximate position of their own country and of foreign countries. In the absence of the statistical material which would enable them to form a reasoned judgment, they have to follow their instinct, which as often as not is wrong. As, under the exchange clearing system, every international payment goes through the hands of the authorities, the system enables them to ascertain the exact position and to act accordingly.

5. Exchange clearing is an inevitable part of any system of efficient monetary management or economic planning. Scientific management of a currency and rational planning of production, distribution, and consumption are simply unthinkable unless a rational method is adopted for international transfers. A reasonably planned internal expansion can be undertaken more safely under exchange clearing than under a system of free exchanges. This does not, of course, mean that under exchange clearing a

country can spend indefinitely without its foreign trade being affected. The degree to which it can expand with impunity is, however, much larger than under a system of free foreign exchanges.

6. Exchange clearing is the one form of international monetary co-operation which does not presuppose either the elimination of political or financial rivalries, or the restoration of confidence between the nations. It can therefore be established and can operate successfully even in the existing atmosphere of distrust and rivalry. For this reason, it is more practicable than any other form of co-operation, since there is but little chance of achieving the ideal state of affairs in international relations, without which other methods of co-operation could not work satisfactorily.

The main objection to the scheme arises out of the method by which, it is expected, the scheme should work as a measure of monetary reform. If the scheme is merely an extension of the principle and method of internal debt settlement applied on a larger scale in international affairs, nothing but good results will ensue. But in order to convert the system into one of monetary reform it is essential that there should be fixity of the relative values of the currencies of the world, abolition of the foreign exchange market, and compulsion of all debtors and creditors to resort to the new institution to be set up in the country for the settlement of all foreign debts. This will involve an interference with the private rights of individuals in foreign trade, which may not be either acceptable or desirable. Secondly, if the relative values of the currencies of the world are fixed in this way, world prices will have their disturbing effects upon internal prices. If ultimately gold has to be used it cannot be considered as an alternative scheme to the gold standard but only complementary to it. In any case, of course, one great advantage remains, *viz*. economy in the use of gold in a world in which the demand for it for monetary purposes appears to be substantially greater than its supply, and in which the situation is further accentuated by its distribution. But to obtain this advantage it is not necessary to go through the full scheme of monetary reform. It will be sufficient if the internal clearing method is extended on a voluntary basis. If the attempt to eliminate gold is persisted in, a third objection will arise. For, in that case, the foreign trade of the

country must be so controlled as to maintain, in the long run, the balance of international indebtedness. In order to be able to do so the international clearing house, which will have to be set up in each country and through which alone all foreign payments will be received or made, must have the right to control the amount of exports and imports. If gold is to be removed from the operation one cannot depend upon gold movements to adjust the final debt balance. Therefore, the foreign trade must be regulated on the understanding that no gold will be required in settling debts. This is possible only when there is an exact balancing of exports and imports, which can be done only by rigid control. It is doubtful whether this interference will not be considered intolerable by the parties or the countries concerned.

It we turn to actual practice we find that of all the schemes for monetary reform proposed in theory or adopted in practice this system has been in use in a larger number of countries. Of course, the system actually in use is not the complete scheme which has been advocated by its supporters. Instead of a general agreement on an international scale we find agreements for exchange clearing between two countries or a few countries at a time. But such bilateral agreements have gradually extended to a very large number of countries in the world. The acceptance of the principle was dictated by the circumstances following on the financial crisis of 1931 and in the course of the next five years, spread very rapidly, especially among the countries of Europe, which, from the economic point of view, are more closely knit together than countries elsewhere in the world. The first clearing agreement was an unostentatious one between Switzerland and Hungary, concluded in 1931. According to this agreement all independent foreign payments between the two countries were stopped. Only the central banks of the two countries were permitted to deal in foreign exchange. The importers of one country would pay in their home currency to the central bank of their country and the exporters would receive payment from the same bank. The two central banks would adjust the payments between the two countries. This system corresponds to the second stage which we have described in connection with the system of internal clearing. Since the first agreement the system has been adopted by many other countries, mostly in the form of bilateral agreements, and its technique also has been considerably improved.

The move for sanctions against Italy, which was mainly inspired by Britain, gave an impetus to the movement towards such agreements and brought in Britain into the system. Strangely enough, although the League of Nations supported the policy of sanctions, it vigorously —but unsuccessfully—opposed the clearing system. An extension of the bilateral agreements took place in central Europe where a few triangular agreements were also concluded. But general agreements of an international character are necessary before the scheme can be said to have come into operation as a comprehensive policy for monetary reform. Also the controls have not yet been adequate nor the international clearing house and the bank for final settlement of debts instituted.

(b) World Money

We now come to the scheme of monetary reform which may be said to be the antithesis of the scheme of national managed currency at the other extreme. This is the scheme for the introduction of one single currency for all the countries of the world. There are several forms which this scheme has taken but we need deal here only with the fundamental points common to all of them. The advocates of one single currency for the whole world expect this currency to be one of paper money controlled and regulated by one bank which will have the power to give the necessary directions to the central banks of all the countries and which will either itself hold all the gold reserves of the world or have adequate control over the gold reserves of all the existing central banks. This bank will allot to each country the amount of bank-notes which it can use and no country will be allowed to have any separate bank-notes of its own. All complications of foreign exchange arising out of differences in the values of separate currencies will disappear and the whole world will normally and easily attain to one level of prices without any movement of gold and subject, as within the same country, only to the cost of transporting commodities.

Those who are cautious and think that such an international agreement to have a single currency or even to have a juster distribution of gold is impossible in the existing conditions of national jealousy and distrust advocate, probably as a transitory system, another scheme according to which the international central bank should start with the power to control and direct the monetary policy

of the national central banks so that there would be introduced a uniform policy regarding money among all the countries of the world. A still more cautious group would not have the international central bank but replace it by an international agreement which will introduce a uniform monetary policy for all the countries so that all conflicts in national monetary policies will be eliminated and each country will definitely know what other countries will do in a given monetary situation.

The objections raised to this scheme in any of the above forms have been strong and even violent. One objection is that swift and immediate decisions, which on occasions, have to be taken in currency matters, will be impossible if an unwieldy committee has got to work. The dilatory proceedings of the committees of the League of Nations justify this kind of apprehension. But this does not appear to be an insoluble difficulty. Nor does it apply to the more extreme proposals which suggest the establishment of the international central bank which, being a single institution, should not find it very difficult to take quick decisions in an emergency. It should also be remembered that such emergent occasions in monetary affairs arise usually out of conflicting monetary policies pursued by different countries and the speculative transactions which ensue from that. If there is one policy and unified control such conflicts and their inevitable consequences will be reduced to a minimum, if not altogether eliminated.

Another objection is regarding the location of the gold reserve. It will be difficult to persuade countries to surrender their gold to the international central bank, for gold is yet the ultimately dependable resource for all monetary and other economic measures that a country may have to adopt. Also in the present political condition of the world a war may break out in which the country may be involved. It will naturally be reluctant to transfer its gold outside its territory. If gold resources are pooled for international purposes but allowed to remain in different countries as they are at present, this objection will be removed. Even then, in case of a war, complications will arise with international currency because the warring country will be able to use its gold independently although this gold is really backing international bank-notes. Thus the currency will, to that extent, be deprived of its gold reserve and yet the country will, in addition to the gold, be in a position to use the

notes which it or its nationals hold in stock. Similar objection arises also in regard to all proposals which have been made for a more equitable distribution of the existing stock of gold. Proposals for foreign loans, international guarantee, etc. have all been suggested and found lacking in necessary support. Further, it has been argued that the keen sense of national sovereignty among the countries of the world will never permit the adoption of a scheme of world money the introduction of which will mean a surrender—even though it would be a partial surrender—of what is considered to be an inherent part of national sovereignty.

In actual practice the first case of systematic co-operation among countries of the world regarding monetary affairs was in stabilising the currency of Austria after the war till the international loan was given to the country in 1923. Such collaboration spread and several other countries of Europe had the benefit of having their currencies so stabilised by joint action on the part of many other countries. Such co-operation was always through the central banks of the country. From this co-operation which cannot be strictly called a measure of monetary reform have grown other policies which can be called so. The collaboration between Britain and the U. S. A. by which the latter agreed to reduce its bank rate in order to avoid an increase in the British bank rate and that between Britain and France by which the latter agreed not to withdraw its gold holdings in Britain may be said to be measures of real monetary reform, for they affected the monetary policy of the countries concerned and showed a realistic appreciation of the inter-dependence of monetary policies of different countries.

In spite of the jealousy and distrust, which undoubtedly exist among the countries of the world and which appear to frighten them whenever proposals for world monetary co-operation are made, co-operation in the international sphere has grown. Many measures have been adopted by joint action, which would have been unthinkable before the war of 1914-18. Just before the war which began in 1939 the world was divided into four monetary groups, *viz.* the sterling *bloc*, gold *bloc*, dollar *bloc*, and "barter" *bloc*. There is no doubt that the origin of these *blocs* was rivalry among the leading countries of the *blocs*, each *bloc* trying to increase its influence with the minor countries of the world and to develop into an independent system stronger than its rivals. But we should not forget that there

is also another side to this picture. That is that as between the leading country and the minor countries within the same *bloc* there has been a much closer co-operation in monetary affairs and these countries represent a unification of monetary policy which is unprecedented in the history of the world. It is always difficult to bring about an agreement among men or countries when their number is very large. The chance for such agreement improves with the fall in the number of the participant countries. From this point of view can we not say that, in spite of the intensification of national rivalries by the formation of currency *blocs*, the prospects for a final world agreement have not receded because now only four main *blocs* are left in the field to negotiate among themselves ? Again, when there is no agreement among a number of countries and when no one country knows what its own following would be the natural desire of each leading country is to strive for increasing its own influence by trying to persuade other countries to come into its monetary orbit and to dissuade them from going into that of its rivals. But once the *blocs* have been formed and fairly well organised each group should know that the others are also strong and that it would be futile or disastrous to attempt to break up the rival *blocs*. With a situation like this the psychological predisposition to come to terms with rivals is strengthened. Therefore, it should be easier now for the four *blocs* to agree to a common policy than when the world was divided into sixty or more warring units of national currencies unconnected with and jealous of one another. Moreover, it would be rash to predict what is and what is not likely to happen after a cataclysmic upheaval like the present war. Almost all the monetary schemes which we have discussed and which in many cases have been tried in some countries or other, as also the series of co-operative decisions which have been taken by voluntary agreement among the countries of the world, would have been considered impracticable, probably chimerical, if they had been suggested in 1914. There is no question that international co-operation in monetary affairs has grown beyond all expectation during the last twenty years. One need not therefore be so pessimistic as to think that the prospect of world money is utterly blank. After the present war many surprises may come and, without attempting to be prophetic, one may say that further international co-operation in monetary affairs may not be ruled out altogether as one of these surprises, especially after its continued progress and at least partial success over the past two

decades. In this connection a scheme which appears to us to have a good prospect for wide acceptance and the principle underlying which has greatly affected the currency policy of all countries since the war of 1914-18 deserves special consideration. That is the system of the gold exchange standard which we shall discuss next.

CHAPTER XV

The Gold Exchange Standard

The fundamental principle of the gold exchange standard is that the home currency is different from the medium of international payment. But the relative value of the two is fixed in terms of each other. It is evident that if this be secured, all the advantages of a gold currency will accrue, for the main object of introducing gold as the currency is to be assured, in times of need, of the adequate supply of a metal which is universally accepted in the settlement of international debts. The working of the system is not very complicated. A gold reserve is built up to ensure that the international currency will be available when required by the demands of external trade. This may be distributed amongst different centres of the world according to the needs of the country for foreign remittances. Bills will be drawn by Government of the country either on itself and sold abroad, or on its foreign gold reserve and sold at home. The amount of such bills would be the difference at any time between the demand for remittances and their supply at par. (1) Thus if at Paris the rate on a country, as quoted in the home currency, goes up, this would show that demand for remittances to the country, whose currency has thus appreciated at Paris, is greater than supply. Bills on that country, drawn against the foreign gold reserve, will be sold at Paris, and their amount would be just enough to bring down the exchange rate to par plus the cost of transporting specie. It is therefore clear that these bills must in all cases be the marginal bills in the market, that is, those bills which are the least profitable ones to come into the market. The gap covered by the excess of demand over supply is just filled up by the sale of these bills. This can be easily managed by an open offer to sell at the fixed rate to an unlimited extent. (2) On the contrary, when the exchange rate falls in Paris, it shows an excess of the supply of foreign bills over demand. At such a time the foreign country whose currency has thus depreciated would draw bills against its gold reserve at Paris and thus choke off

some bills at Paris by supplying remittances to the foreign debtors of Paris exporters. Or, in such a case the French Government may undertake to sell in the foreign country remittances to Paris, with the same result, *viz.* to push up the exchange rate at Paris. The French Government would do this whenever it finds this to be a cheap means of building up a reserve in the particular foreign country. In the first case the bills will be drawn against French gold reserve in the foreign country but paid in the currency of that country, which will be easily available there. In the latter case the bills will be sold in foreign currency but matured in French currency. If they are sold by the French Government the sale proceeds will add to its gold reserve in the foreign country; that is, the foreign country will convert the sale proceeds of the bills realised in its currency and credit France with a corresponding amount in its gold reserve. It is evident that actual gold need not pass even between the agency of the French Government and that of the Government of that foreign country, because an accommodation like this in terms of gold will be required by the French Government mainly to sell in Paris bills against it, and these will be paid in the foreign currency. What the French Government needs to be sure of is the fact that the reserve which it has built up in the foreign country by a sale of bills on Paris will again give it an equivalent amount when Paris bills are drawn against the reserve.

Within the country the home currency will consist wholly of token coins and notes, including the full legal tender money. Government will guarantee an unlimited conversion of the home currency into gold bills, and *vice versa*, thus always ensuring that the exchange rate will not vary beyond certain maximum and minimum limits. These limits are usually fixed at the specie points. Thus all bills sold by Government will bring some profit to Government inasmuch as the foreign reserve will normally be built up at the gold import point and the bills will be sold at the gold export point. All this profit is to be earmarked for swelling the gold reserve. The main portion of the reserve will be built out of the profits of coinage. The home currency being wholly of token coins and notes, its issue will mean profit to Government. This should be utilised in piling up the gold reserve of the country.

Thus the gold exchange standard will bring about the following advantages:

(1) Economy in the cost of the home currency. Moreover,

gold will fall in value if national assets are not locked up in financing the actual circulating media of a country. At the same time the present stock of gold can be utilised for the new gold reserve for exchange purposes. On the other hand the profit derived out of token coins will be used also in buying gold for the reserve, and, to this extent, which will be much less than what would be required if the home currency were gold, the demand for gold will rise.

(2) Economy in building up the gold reserve. The profiit out of minting token coins will swell the gold reserve or accommodation in foreign currencies fixed in terms of gold. It is evident that, in the beginning, the first and second advantages cannot both accrue, since, to secure the second, the first will be swallowed up. But that will be so only till a working reserve has been secured. After that, instead of all the profit only a certain proportion, fixed and definite, may be thus utilised. The rest will be the net profit to the country. To the extent that notes can displace actual coins, there will be further economy to the country because the note issue is nothing but token money without much cost of minting.

(3) The exchange rate will be as stable as it could be under the old system because the fluctuations can never go beyond the limits fixed by the gold points. Probably they will be less, especially when the movement of gold is minimised by the introduction of the system of granting credit to a country in a foreign country against the former's holding of gold in a third country ; which of course will be earmarked for such credit till it has matured and has been met.

(4) There will be international guarantee against seizure of this gold reserve in foreign countries. This will assure international trade of a medium of settlement, which will be available for this purpose alone. The guarantee will further enhance the international credit of a country, because by it the reserve cannot be sequestered in any circumstances. Similarly the internal law of the country will gurantee against its sequestration by itself for any purpose other than

the maintenance of exchange, that is, settlement of its external debt. The amount of this reserve together with the condition of its external trade or rather the balance of its outstanding external debt will determine at any time the international credit of the country, inasmuch as this will show the capacity of the country to finance its external trade when its imports and exports, visible and invisible, do not equate. The main attempt of each country should be to accumulate a reserve which is not excessive because that would mean a national wastage but which is certainly not below what is required by the conditions of its external trade. Thus it will be cheaper for a country to build up its foreign reserve if it has a favourable balance of trade as it can sell remittances to itself from foreign countries. But the cost, in any case, can never exceed the expenses of shipping gold. An adverse balance of trade will necessitate a sale of bills on foreign countries. This, however, need not necessarily mean the transport of gold to those countries. If those countries buy accommodation in the country concerned, guaranteed by the gold which must be sent to meet the adverse balance, it can receive similar accommodaion in those countries, against which it can, in its turn, sell bills. In this operation what are known as arbitrage transactions will necessarily enter, and the chances of loss by fluctuations in the exchange rate will be further reduced. In any case, if the country is solvent in the long run, that is, if ultimately its debt balances its credit, as there must be under the operation of economic forces, the exchange rate cannot fluctuate beyond the gold points. The fluctuation will reach gold points only for a time during which a tolerably good reserve is being built up. After that the fluctuations will be further limited. At the same time all the advantages mentioned in (1) and (2) above will accrue to the country.

(5) One advantage of the gold exchange standard over the bimetallic and other systems is that it can work with countries on a gold basis. Even if a country refuses to accept it out of habit, pre-conceived ideas, or anything

else, this will not hinder other countries from adopting it and yet carrying on international trade with gold-using countries. If, for example, Greece sticks to the use of gold, France or Britain, if it adopts the gold exchange standard, can sell bills in Greece on Paris or London and pile up its gold reserve there at a time of favourable balance and sell bills in Paris or London on Athens at a time of adverse balance. For the latter contingency it must have a reserve in Greece or in any other country, bills on which are in demand in Greece. Of course, if all the countries join together and use token coins and notes as their home currency, the gold reserves can be cheaply built up since the gold circulating at home will thus be liberated and earmarked for the settlement of international debts.

(6) In the beginning the gold reserve must remain as the basis of all such settlement. But when the war conditions disappear and the normal working of the system continues, it is not necessary for actual gold to be passed from one country to another. Gold, for example, may be definitely set apart for supporting the exchange rate with another country, and gold certificates may be issued against the reserve, which the Government of the other country will recognise as representing gold. This involves international guarantee of the gold reserve and the local Government's good faith in not diverting this reserve so long as the gold certificates in the foreign countries have not been paid off by a sale of bills on its own country, drawn in the country where the gold certificates originated. These transactions will have to be done under the sanction of the Government concerned but through a recognised bank. The greatest publicity should be given to the amount of the gold reserve as earmarked for supporting the exchange rate with a particular country; to the amount kept fluid, ready to be turned for other exchange purposes; as also to the variations in each from time to time, say, from week to week. Further, when the system has worked for some time, the problem of whether, instead of gold certificates, that is, representatives of actual gold kept in the reserve, international credit papers based on gold can

be created, may be profitably discussed. The gold reserve will thus work exactly like the cash reserve in the home currency, kept against the note issue. This will mean further economy in the use of the metal as international money. This system, if properly handled by an international body, can reduce the uncertainties of fluctuations in the value of gold, which are sometimes a highly disturbing factor, especially with regard to the disturbances in the level of world prices. This is a highly subtle operation but it seems to be not altogether outside the range of practical considerations.

All the foreign operations can conveniently be carried on by the central banks of the different countries, as, for example, the Bank of England working on behalf of the British Government.

There are however certain drawbacks of the proposed system, which should be carefully studied and their working properly comprehended.

(1) One drawback is said to be that the gold exchange standard is a Government managed system and not automatic. Of course, it is managed by Government. But it is nevertheless automatic. The first essential for a currency is that its amount should increase or decrease according to the need, that is, according to the volume of transactions to be carried on with the currency. If, for example, there is an adverse balance of trade, it shows that the country is a good market to sell in and a bad one to buy from. The reverse process is at once started by the efflux of gold to meet the adverse balance when the reduction in the home currency increases its value and diminishes the prices, thus making the country a better market for buying and a worse one for selling. If this be considered as the fundamental feature of an "automatic" as opposed to a "managed" currency, then the gold exchange standard can be said to be automatic even if it be managed by Government. Let us suppose that both Britain and France have adopted the proposed system; let us also suppose that exports from Britain to France are greater than the imports. Under the old system gold will flow from France to Britain, swell its currency, and push up British

while the contrary will be the case in France. The remedy will thus be found by cheapening French products in Britain and making British products dearer in French money. Therefore, French exports to Britain will increase and British exports to France will diminish. Thus the balance of indebtedness will be restored. It should be noted that the amount of export, which is invested abroad, does not affect foreign exchange so long as it or its income is not remitted from one country to another.

Now let us see what will be the case when Britain and France, in our foregoing illustration, are under the gold exchange system. To make payment to the British creditors, French debtors will, as under the old system, try to buy bills on London. But as the amount of these represents the amount of British debt to France, it will be less than the French debt to Britain because there is, as is supposed, an adverse balance against France. So, the sterling will tend to rise in terms of franc, and as gold is not circulating in either country, the rise in the exchange rate will tend to be indefinite, limited only by the extent of the token character of the coins, if any, in circulation, or the facility of buying gold as a commodity in France. But here Government will intervene and offer to sell an unlimited amount of sterling realisable in London at a rate corresponding to the gold point. This will at once check the rise by neutralising the excess of demand over the supply of sterling bills. By their sale the French Government will realise, in French home currency, the amount of the sterling in terms of the franc. This will be rigidly kept out of circulation as a part of the home reserve for maintaining the exchange rate, and therefore the amount of French currency being reduced, it will rise in value and bring about a fall in prices. At the same time these foreign bills will be presented in London and paid in British currency out of the accommodation which the French Government will have from the British bank against the French gold reserve in London. This will swell the currency in Britain, bringing about a fall in its value and a rise in prices This is exactly the process

which it is intended to have in operation in the case of an excess of British exports over imports and this is exactly what the old system normally did. The point to be noted is that the French currency thus locked up should never be liberated except to mature Paris bills sold in other countries to maintain the exchange rates. It is in this way alone that the home currency will respond to the joint stimulus of home and foreign trade. And this is what is meant to be secured when it is demanded that the currency should be automatic. Thus it will be seen that a "managed" currency and an "automatic" currency are not two contradictory conceptions as in the popular mind but that the two principles can be combined in the exchange standard system.

(2) It is evident that, to secure the greatest economy, it is essential that the home currency should consist of very cheap metals, so long as metals are considered to be necessary parts of the home circulation. This means that silver and other metals will be used as token coins. It may be anticipated that the countries adopting the gold exchange standard will have more coins of silver, displacing gold. This means that the value of token silver coins must remain below their face value as fixed by the exchange rate adopted and maintained by the Government of the country. Want of this led to grave troubles in India during 1917-20, especially in 1919-20. It is evident that if the price of silver rises in terms of gold and sweeps away the token character of silver coins circulating in different countries, it will be profitable to utilise such token coins as bullion and use them for other than currency purposes. For example, India till 1916 had a fixed exchange of 1s 4d to the rupee, the rupee containing metal roughly worth two-thirds of the face value. By 1917 the price of silver increased so much as to make the intrinsic value of the rupee more than its face value as fixed by law and maintained in exchange. Government had no alternative but to raise the exchange rate to cover the rising value of the metal. The sterling value of silver rose from below 28d per ounce to about 90d. Apparently the

rupee coin was threatened. The exchange rate had to be raised to more than 2s 10d and Government had to support this rate by selling bills in India on its gold reserve at London. The resources of Government were too limited to meet the unforeseen and unprecedented rise in the gold value of silver. During the last half of the nineteenth century the fall in silver unnerved all the countries of the world and several international monetary conferences were held to stabilise, if possible, the gold value of silver. But then the price of silver varied from 59½d per ounce in 1844 to 42d in 1889, a fall of about 30 per cent. Whereas the sterling value of silver in 1920 as compared with that of 1914 rose by more than 200 per cent, from which the extent of sterling depreciation will have to be deducted to find the net variation ; this latter was about 30 per cent. Therefore, we may say that the variation in the gold value of silver was unprecedented, and, humanly speaking, no country could have made provision for such a rise in anticipation of events. In such extreme cases the exchange rate will have to be altered to protect the coins unless a country is prepared to give up its coins of a particular metal the gold value of which rises. But ordinarily the best insurance against such a contingency is to have a token silver coin, the face value of which will be considerably above its metallic value, so that any probable rise in silver will not easily swallow the margin by which the coin is made token. If this is done, then this feature, intead of being a drawback of the proposed system, becomes highly economic in two ways. First, it makes it less costly for a country to have its coin circulation thus reducing the cost of national investment in the home currency. Secondly, as the profit of coinage, or a good portion of it, is to be utilised for building up the gold reserve, the resources of the country to have its gold reserve increase with the margin which is kept between the face and metallic values of the silver coin. To the extent that gold coins are kept for home circulation this contingency does not arise. The above considerations *ipso facto* apply to token coins of other metals.

(3) There is the danger of currency inflation which, it may be urged, will increase if the system be adopted. When the pre-war system is in normal working order, any divergence between the value of the coin and that of its metallic content is quickly reduced through the system of free coinage. But under the exchange standard system the mint being closed to the public, there will not be any such increase in the coins nor will there be a reduction by melting since the coins will be token ones. In this consideration we should not lay too much emphasis on the function of coins in the determination of prices. The limitations of the quantity theory of money should be recognised. Even in the old system money had been displaced to a considerable extent by notes, and where, as in Britain, the note issue was very rigidly limited by the legal conditions regarding the metallic reserve, the law was successfully dodged, to the great benefit of the country, by the development of the system of cheques, bills, and advances by book-credit. The Bank Charter Act of 1844 might have frustrated the economic progress of the United Kingdom if the cheque system had not taken up the work which the Act sought to restrict. In Germany the British system was relaxed by allowing an excess issue on emergent occasions on payment of a tax of five per cent. The argument may be advanced that the notes, being legal tender, should be cautiously guarded. This is right, and this can be attained in the exchange standard system by carefully noting the broad variations in the purchasing power of money and making the home currency elastic enough to respond to such variations. In such response plenty of caution can be exercised and the amount can be made to grow with the growth of demand for money. But the fact needs to be emphasised that the internal trade of a country can be and, in all advanced countries, is actually financed by the credit system which has been developed so wonderfully, and the evils from the break-down of which were so patent after the last war. Thus the home currency need not in itself be so responsive to the demands of internal trade. It was not so before the last war disorganised the old system. Rather it should respond to the

movements of external trade where bills are considered, either really as in the case of "drafts with documents", or fictitiously as in the case of "accommodation bills", to be the crux on which the exchange rate largely depends. Moreover, bullion as money enters only in international payments as a determinant of values. Therefore, the response which a country should aim at can be secured, as has been shown previously, by locking up the proceeds in the home currency, out of the sale of bills in foreign countries against the gold reserve and releasing them only in payment of bills drawn by Government on itself and sold in foreign countries to support the exchange rate or add to its gold reserve in those countries.

If it be considered essential to have the home currency immediately responsive to the internal trade conditions without, as is really done, having an inflation or deflation of the credit system, this also is claimed for the exchange standard system. Odinarily when gold rises as bullion, coins are withdrawn from circulation to be used as metal, and when it falls, bullion is brought to the mint. In the exchange standard system when gold falls in terms of the token coin at its face value, Government would be prepared to receive gold and issue the home currency at par in exchange for it. When gold rises Government would accept the home currency and release the gold locked up by the former process. But this demand for gold cannot be for an indefinite quantity because this gold cannot be coined and therefore can have only bullion value within the country. To begin with, the export of this gold will have to be restricted as it is done at present by all the European countries. Or, instead of releasing gold within the country, gold bills may be issued on another country as are done by India on London in the form of sterling drafts called Reverse Council Bills. In either case the ultimate effect on the home currency will be the same.

(4) It may be objected that the cost of building up and maintaining a gold reserve dispersed in many countries will be very great. It is argued that this should not act as a deterrent inasmuch as such cost can never even

approach what will entail if an attempt be made to rehabilitate gold as the circulating medium of the countries of Europe. Moreover, the gold reserve will be kept at different places also for the sake of economy. For example, if in Sweden bills on Paris be at a premium, the obvious interest of both Sweden and France under the exchange standard system will be to sell bills in Sweden on Paris. Sweden will do so to add to its gold reserve at home and France to add to its reserve in Sweden. In either case these bills will be sold at a rate approximating to the gold export point, since they supply a market which is short of bills; that is, the value of kronor in terms of franc will have gone down. This means that the gold reserve in Sweden, whether accumulated by that country or by France, will grow at a cost less than it would do at par. Therefore, the proposed dispersion of the gold reserve of a country is meant for further economising the cost of building up the reserve. Such a reserve may be at home or at any important centre abroad. When the system has developed sufficiently it will not be necessary to transmit gold from the reserve in one country to that in another, but gold certificates or even credit papers can be issued in one country backed by the gold in the reserve held in another country but earmarked for the redemption of such certificates or credit papers. Even with regard to the cost of holding such reserves it is not necessary to have them separately at the same centre by the different countries, but the local bank, *e. g.* the Bank of England in London, may keep them and charge the cost to those countries. With international guarantee of the integrity of the reserve, the cost of maintenance will be materially reduced.

Some of the possibilities of expansion of the gold exchange standard, which are advanced by its supporters, have been incidentally noted in the foregoing discussion of its underlying principles. Here we may conveniently summarise them:

(1) The central bank in each country will do the work on behalf of the Governments of the different countries. This will considerably reduce the cost of maintaining the reserves, and the publication of the reserve accounts

separately will materially help to inspire confidence. When the working of the system has developed, a further development will be the establishment of an international clearing house of these banks, first to square the reserve accounts and then to settle international bill debts in one country against credits in another. Thus even the international movement of gold on Government account to encash exchange bills or secure gold will be obviated to a large extent.

(2) The banks will have international accounts. These will be credited or debited against gold held at any of the central banks doing exchange business on behalf of the various countries. Through the international clearing house the total reserves of any country held in all the countries will be unified and therefore more effectively used than they could be if each reserve were separate and unconnected with others.

(3) Thus gold reserves need not be held in all the different centres with which a country has dealings. These may be built up only at convenient centres or even at one centre and credit obtained, through the central banking organisation, in other countries where a country has no gold. For example, in Europe London may theoretically be the only centre of international gold reserve. Others may be at Tokyo, New York, etc.

(4) The clearing house system, starting with the exchange operations in the exchange standard system, may be spread to other operations of the central banks. This will be only an extension of the system which was already working to some extent in Europe before the last war. But the solidarity of interest, as developed through the exchange reserve system, with international guarantee, is bound to reflect upon the efficiency and ease with which other operations of the central banks than exchange ones can be carried on.

(5) The unification of the reserves of each country and the international guarantee will necessarily secure for a country better credit in the world market. Gradually, through the same system and on the basis of the reserves, an entirely

new credit system may be organised. Like the fiduciary portion of the note-issue in the home currency international credit papers may be issued, which will have as free circulation in the international market as the home currency within a country. Such an issue will be of a much later date, but there is no reason why it should not succeed if, through the central banks, these credit papers are issued on purely business principles and if their issue be properly safeguarded by an international agreement on the principles, for example, of the English Bank Charter Act ; or, on a more elastic basis like that in Germany with a high penalty for any excess issue ; or, on the principle of the proportional reserve as in the U.S.A.; or, on a combination of the two principles, that is, the system of proportional reserve with further elasticity on payment of a penalty up to a certain amount, beyond which, like the British system, there shall be no further fiduciary issue.

6) Through the same organisation international borrowing may be facilitated. This borrowing may be either in the form of loans or merely credit accommodations. That is, it may be either a regular loan, or, like the treasury bills at home, temporary only. In the latter case, in the beginning at least, the floating debt should be kept within a statutory limit.

The fundamental point in the whole system as adumbrated above is of course the international guarantee that, in no circumstances, the gold reserve of one country will be seized by another country. Such an act must be agreed to be considered as *casus bellum* without any hedging condition. That is why it must be accepted by international agreement before it can have any hope of success. According to the supporters of the scheme it is the only economical method of rebuilding the currency and exchange stability of the world in general and Europe in particular, and upon this depends not only the material development of Europe but of the whole world. Therefore, in the interest of each State separately and all States jointly, the gold exchange standard has been urged for adoption both by those who intend permanently to adopt it and by those who intend temporarily to adopt it with a view to converting it into a gold standard as soon as the economic prosperity of a country

justifies the investment of a large amount of national wealth in the mere circulating medium within the country.

In the twenties there was little chance of recovery from the currency disorganisation in the European countries east of the Rhine. In other words, more than two-thirds of Europe was not expected to recover if the gold currency was sought to be re-instated. Of these parts Germany was the only country which probably might recover but now its case also is hopeless. Therefore, a cheap and effective method of currency recovery will have to be found if the delicate balance of the economic situation in Europe is to be restored. In this monetary recovery not only are the more favourably placed countries of Europe concerned but all the countries of the world. Japan suffers from want of sufficient demand for its goods. India is passing through a similar crisis; its exportable surplus cannot be absorbed so long as the currency and exchange system of Europe is not placed on a sound footing. The United States is also suffering from the same want of demand for its exports. At the same time a large portion of humanity is suffering agony from want of goods which glut the extra-European markets. Humane sentiment and self-interest thus combine to urge the great countries of the world to help the rebuilding of Europe. Besides the balancing of the budgets an essential condition of such work is to re-organise the currencies of those countries, and, in doing so, one must not lose sight of the cost of the home currency. The home currency in most countries consists of inconvertible paper, but within the countries themselves the paper has been circulating. The main problem therefore is to stabilise foreign exchange, that is, the value of the home currency in terms of foreign currencies or preferably gold, and simultaneously to reform as rapidly as possible the home currency. The latter will be rapid in proportion as it is cheap. The recovery will be effective in proportion as it is not merely a makeshift but based on a system which can work permanently. The gold exchange standard claims to have both these essentials. It is cheap inasmuch as it dispenses with the national investment of a large sum in the home currency, releases most of the existing gold reserves to stabilise the external value of the home currency, and further provides for a development of the reserve in proportion to the increase in the volume of transactions, which, by demanding more of the home currency as time goes on, will swell the profits of coinage to be utilised for the exchange

reserve. The system is permanent inasmuch as it will work with equal efficiency when normal conditions are restored.

It may be pointed out that the gold exchange standard will not hinder any country from subsequently adopting the gold currency. When the gold reserve is sufficiently large and when time is considered to be ripe for it, the reserve may be utilised in replacing the token legal tender by gold coins and in withdrawing the token coins and notes in exchange for the new coins. Thus the system can be adopted not only by those countries which intend to stick to it but also by those which want ultimately to have the gold currency and are unable to finance it now. Unlike national bimetallism it has the further advantage in being able to work efficiently side by side with the gold currency in the neighbouring countries.

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